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100-10111-1
FEDERAL INSURANCE ACT OF 1977

95-1
HEARINGS

BEFORE THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-FIFTH CONGRESS

FIRST SESSION

ON

S. 1710

TO AUTHORIZE THE ISSUANCE OF CHARTERS FOR CARRY-
ING ON THE BUSINESS OF INSURANCE TO PROVIDE FOR THE
GUARANTEE OF THE INSURANCE OBLIGATIONS AND FOR
OTHER PURPOSES

SEPTEMBER 12, 13, AND 14, 1977

Printed for the use of the Committee on Banking, Housing,
and Urban Affairs





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FEDERAL INSURANCE ACT OF 1977

MONDAY, SEPTEMBER, 12, 1977

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:40 a.m., in room 5302, Dirksen Senate Office Building, Senator William Proxmire, chairman of the committee, presiding.

Present: Senators Proxmire, Sparkman, Brooke, and Lugar.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

The committee today begins 3 days of hearings on S. 1710, the Federal Insurance Act of 1977.

In the past couple of years there has been increasing concern about the financial condition of insurance companies. The GEICO situation received a great deal of press attention and caused much anxiety to policyholders. It raised considerable doubts about the ability of the present system to cope with a major insurance insolvency.

The bill before us today seeks to bolster the financial stability of the property casualty insurance industry by offering on a voluntary basis a Federal alternative to the present system of State regulation of insurance companies.

S. 1710 would, in effect, create a dual insurance system similar to the dual banking system which has long existed in this country.

We do this in the following ways. First, by establishing a Federal insurance guarantee program similar to the Federal Deposit Insurance Corporation for financial institutions as an alternative to the present network of State guarantee funds; and, second, by providing a Federal chartering alternative for insurance companies similar to that which is available to banks and savings and loan associations under the dual banking system.

I am reluctant at this point to take yet another step toward involving the Federal Government in private business and toward encouraging more bureaucracy and more red tape. The burden of proof in this case must rest with those that argue that more Federal intervention in the insurance industry is needed. They will have to make a strong case that the problems arising in interstate insurance transactions threaten the interest of policyholders and the public generally, and that State legislation alone cannot deal with these problems.

I'm sure that points will be made on both sides of the issue in the course of these hearings. Senator Brooke is the author of S. 1710. He and his staff have done an excellent job of drafting the legislation and arranging this initial set of hearings to air the basic questions.

Senator Brooke, I understand you have an opening statement.

OPENING STATEMENT OF SENATOR BROOKE

Senator Brooke. Thank you, Mr. Chairman.

Mr. Chairman, on June 16 of this year I introduced S. 1710, titled The Federal Insurance Act of 1977. This bill is a revised version of S. 3884 which I introduced at the end of the 94th Congress. The bill grew out of my concern about the financial condition of the property casualty insurance business.

In 1974 and 1975 property casualty companies experienced the 2 worst years in their history with combined underwriting losses totaling \$7 billion for the 2 years, and there was a considerable concern at that time that one or more major insurance companies would be declared insolvent.

A year ago newspaper headlines were speculating on the possibility of the failure of the Government Employees Insurance Co., GEICO, and the effect of such a failure on the policyholders of that company. The New York Times on June 11 of last year reported that there was a consensus that the already strained guarantee fund pools could not handle the intense claim activity of a GEICO portfolio.

The weakened financial condition of the property casualty industry and the possibility of a major company failure prompted me to consider what steps might be taken to insure protection for policyholders and to improve the quality of regulation for solvency.

Since last year the outlook for the property casualty insurance industry has improved. According to Best's Review, in 1976 underwriting losses totaled \$2.2 billion. While preliminary first quarter figures for 1977 indicate underwriting losses in the range of \$484 million, it is expected that second quarter figures will show a turnaround in underwriting results. Also, the GEICO situation appears to have turned around. But the mere fact that the \$2.2 billion in underwriting losses can be regarded as an improvement shows how deeply troubled the property casualty industry has been.

Of course, I hope that the worst is over and that the industry will make a strong recovery, but the trauma of the last few years has brought home to me the need to improve the protection available to insurance policyholders before the next brush with disaster.

On May 25 the Washington Post carried a story entitled, "How an Insolvent Firm Keeps Selling Insurance." According to that article, as of last May, the approximately 175,000 policyholders of New South Life Insurance Co. of Columbia, S.C., were unable to exercise their rights to obtain the cash surrender value of their policies or to borrow against their policies because since 1971 New South had been insolvent and policyholders' funds are being used, interest free, to bail out the company and its owners. Yet New South salesmen are still selling policies to unsuspecting buyers who apparently are unaware of the company's financial condition. According to the Washington Post, about

90 percent of New South policyholders are poor blacks living in rural parts of South Carolina.

I hope that the New South case is atypical, but I think it points to the abuses which can arise under our current scheme of solvency regulation.

Presently, the policyholders obligations of insurance companies are protected by a system of State insurance guarantee funds which was set up in the late 1960's and early 1970's after a spate of insurance company bankruptcies left insurance policyholders without insurance protection. These guarantee funds are designed to provide for the payment of claims against covered individuals when their insurer fails. Since 1969 these funds have disbursed about \$104 million in 106 insurance company insolvencies. However, the funds have yet to face the collapse of a major insurer, and most knowledgeable observers question their ability to do so.

Furthermore, while 46 States have guarantee funds to protect against the failure of property casualty companies, only 18 States presently offer guarantee fund protection against a life insurance company insolvency. Since each State runs its own guarantee fund, the effort to prevent or control insolvencies is fragmented and ineffective. Uniform standards for guarantee status have not been developed by the States and the prospect of a number of States scrambling to secure control of the assets of a failed insurer to meet policyholder obligations within their jurisdictions does not present a pretty picture.

Assessments to pay for insolvency are made after the fact and they are levied at the time when many companies have troubles of their own which may be aggravated by the necessity of paying an assessment, thus posing the threat of a domino effect. This threat is somewhat mitigated by the fact that assessments are limited by statute to about 1 percent of a company's premium volume in about one-half the States and 2 percent in the rest, but this very limitation means that most funds would not be able to deal with a major failure or multiple failures in a timely fashion.

Where State guarantee funds have been operated on a preassessment basis, they have proven to be subject to the whims of the State legislature. New York State's funds amassed \$240 million through assessments and interest income. However, to help alleviate New York State's fiscal crisis, the New York State property and liability insurance security fund switched more than \$200 million from bank certificates on deposit and Federal Government securities into New York State obligations. Thus, the New York State fund was illiquid just at the time when it was most likely to be called upon to deal with an insurance company insolvency.

Now these and other weaknesses in our present system for dealing with insurance company insolvencies have convinced me that it would be desirable to create an alternative system of regulation for solvency purposes.

The bill which is the subject of our hearings today would seek to improve the quality of insurance company regulation by providing for an alternative system of Federal regulation similar to the Federal regulatory alternative presently available to banks and savings and loan associations under what has come to be known as the dual banking system.

I believe that the existence of such a system of alternative regulation would provide a check against both inadequate regulation and over-regulation at either the State level or the Federal level. The bill consists of two titles. Title I would create a Federal insurance guarantee program similar in concept to the Federal Deposit Insurance program available in the banking field. Title II provides a Federal chartering alternative for insurance companies similar to the Federal chartering alternative presently available to banks and savings and loan associations under the dual banking system.

Mr. Chairman, I would ask that a section-by-section analysis of the bill be included in my remarks.

The CHAIRMAN. Without objection, that will be done.

[S. 1710 and the section-by-section analysis follows:]

[S. 1710, 95th Cong., 1st sess.]

A BILL To authorize the issuance of charters for carrying on the business of insurance, to provide for the guarantee of the insurance obligations, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act, together with the following table of contents, may be cited as the "Federal Insurance Act of 1977":

TABLE OF CONTENTS

- Sec. 1. Short title.
Sec. 2. Definitions.

TITLE I—FEDERAL INSURANCE GUARANTY PROGRAM

- Sec. 101. Federal Insurance Commission.
~~Sec. 102.~~ Federal Insurance Guaranty Fund.
Sec. 103. Federal Guaranty Certificate.
Sec. 104. Satisfaction of guaranteed obligations.
Sec. 105. Procedures to avoid default.
Sec. 106. Procedures for rehabilitation, reorganization, or liquidation of a federally guaranteed insurer.
~~Sec. 107.~~ Regulatory authority.
Sec. 108. Supervisory authority.
Sec. 109. Competition.

TITLE II FEDERAL CHARTERING OF INSURANCE COMPANIES

- Sec. 201. Chartering.
Sec. 202. Organization.
Sec. 203. Commencing business.
Sec. 204. Applicability of State law
~~Sec. 205.~~ Investments.

DEFINITIONS

SEC. 2. As used in this Act—

- (1) the term "Commission" means the Federal Insurance Commission;
- (2) the term "federally chartered insurer" means an insurer or surety chartered under the provisions of this Act to transact an insurance or surety business;
- (3) the term "federally guaranteed insurer" means an insurer or surety whose insurance obligations are guaranteed under the provisions of this Act;
- (4) the term "State" means any State of the United States and the District of Columbia;
- (5) the term "fund" means the Federal Insurance Guaranty Fund established pursuant to section 102;
- (6) the term "guaranteed obligation" means (A) an insurance obligation to a policy holder, a claimant or an insured, or an assignee of any of them, within the coverage of a policy guaranteed in accordance with this Act; or (B) the right of a policyholder, an insured, or an assignee of either of them for returns of premium due as a result of the termination of the policy

guaranteed in accordance with this Act by reason of insolvency arising while the insurer was a federally guaranteed insurer;

(7) the term "insolvent insurer" means an insurer which has been adjudicated insolvent by a court of competent jurisdiction;

(8) the term "insurer" means any person which is engaged in transacting insurance or suretyship as a principal in interstate commerce or which is reinsured in interstate commerce;

(9) the term "insurance" means a contract whereby one undertakes to indemnify another or pay a specified amount or provide a designated benefit upon a determinable contingency;

(10) the term "interstate commerce" means trade in or affecting commerce between or among the several States;

(11) the term "net direct premiums written" means direct gross premiums written on policies guaranteed in accordance with this Act less return premiums thereon and dividends paid or credited to policyholders on such direct business;

(12) the term "operating expenses" means all administrative expenses of the Commission, including but not limited to salaries, office supplies, and other business expenses, but does not include (A) allocated and unallocated claim and loss expenses arising from payment of guaranteed claims; or (B) interest on any Treasury loans (but does include payment of interest on capital stock advanced);

(13) the term "person" means an individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization, or any other similar entity;

(14) the term "policy" means any contract of direct insurance or surety, including any endorsement, binder, (written or oral), cover note, certificate, or other instrument of insurance attached or relating thereto, without regard to the nature or form of the same;

(15) the term "State supervisory authority" means the agency or official of a State having responsibility for regulating the business of insurance within that State;

(16) the term "transacting" with respect to insurance means any of the following:

(A) solicitation and inducement;

(B) preliminary negotiations;

(C) effectuation of a policy; or

(D) transaction of matters subsequent to effectuation of a policy and arising out of it; and

(17) the term "insurance obligation" means any unsatisfied obligation, excluding amounts due any reinsurer, insurer, insurance pool, or underwriting association, as subrogation recoveries or otherwise—

(A) which exists under and within the coverage and limits of insurance policies issued by any insurer adjudged to be impaired or insolvent; and

(B) which has been finally determined administratively or judicially under applicable State law to be valid and certain as to its terms.

TITLE I—FEDERAL INSURANCE GUARANTY PROGRAM

FEDERAL INSURANCE COMMISSION

SEC. 101. (a) There is hereby established a Federal Insurance Commission, which shall be an independent agency in the executive branch and shall have the powers hereinafter granted.

(b) Upon the date of enactment of the Federal Insurance Act of 1977, the Commission shall have power:

(1) To adopt and use a seal.

(2) To have succession until dissolved by an Act of Congress.

(3) To make contracts.

(4) To sue and be sued, complain and defend, in any court of law or equity, local, State, or Federal. All suits of a civil nature at common law or in equity to which the Commission shall be a party shall be deemed to arise under the laws of the United States, and the United States district courts shall have original jurisdiction thereof, without regard to the amount

in controversy; and the Commission may, without bond or security, remove any such action, suit, or proceeding from a State court to the United States district court for the district or division embracing the place where the same is pending by following any procedure for removal now or hereafter in effect. No attachment or execution shall be issued against the Commission or its property before final judgment in any suit, action, or proceeding in any local, State, or Federal court. The Commission shall designate an agent upon whom service of process may be made in any State to which any federally guaranteed insurer is transacting insurance or has its principal place of business.

(5) To appoint and fix the compensation of such officers and employees as it deems appropriate.

(6) To exercise all powers specifically granted by the provisions of this Act, and such incidental powers as shall be necessary to carry out the powers so granted.

(7) To make examinations of and to require information and reports from all federally guaranteed insurers or applicants for a guaranty or charter, their managers and agents, as required in this title.

(8) To cooperate and coordinate with State supervisory authorities and associations thereof on matters affecting the solvency of federally chartered insurers.

(9) To act as receiver, trustee, rehabilitator, or liquidator.

(10) To prescribe such rules and regulations as it may deem necessary to carry out the provisions of this Act.

(c)(1) The Commission shall consist of three members, who shall be appointed by the President, by and with the advice and consent of the Senate. One of the members shall be designated by the President to be the Chairman of the Commission. Not more than two of the members of the Commission shall be members of the same political party.

(2) Each member of the Commission shall hold office for a term of six years. In the event of a vacancy in the office of the Chairman of the Commission, and pending the appointment of a successor, the more senior of the remaining members shall act as Chairman.

(3) The Chairman of the Commission shall have executive authority within the Commission, including the authority to employ and direct the personnel of the Commission.

(4) The members of the Commission shall be ineligible during the time they are in office and for two years thereafter to hold any office, position, or employment in any federally chartered insurer, except that this restriction shall not apply to any member who has served the full term for which he was appointed. No member of the Commission shall be an officer or director of any insurer or hold stock in any federally chartered or guaranteed insurer; and before entering upon his duties as a member of the Commission he shall certify under oath that he has complied with this requirement and such certification shall be filed with the Secretary of the Commission.

(d)(1) There is hereby established an Advisory Committee consisting of the Special Assistant to the President on Consumer Affairs, ex officio, a representative of the Secretary of the Treasury, ex officio, a representative of the Secretary of Housing and Urban Development, ex officio, and ten members appointed by the Chairman of the Commission of whom four shall be selected from among persons actively employed in the private insurance industry (including one representative of the reinsurance industry), three shall be selected from among persons actively engaged in State supervisory or legislative activities, and three shall be selected as consumer representatives of the general public.

(2) The Chairman of the Commission shall designate a Chairman and a Vice Chairman of the Advisory Committee.

(3) Each member shall serve for a term of two years or until his successor has been appointed and shall have qualified. Members may be reappointed, except that no person who is appointed from among persons actively employed in the private insurance industry or from among persons actively engaged in State supervisory or legislative activities shall serve in such position after he ceases to be so employed, unless reappointed in another capacity.

(4) Any member appointed to fill a vacancy occurring prior to the expiration of the term for which his predecessor was appointed shall be appointed for the remainder of that term.

(6) The Vice Chairman of the Advisory Committee shall preside in the absence or disability of the Chairman. In the absence of both the Chairman and Vice Chairman, the Chairman of the Commission may appoint any member to act as Chairman pro tempore. The Committee shall meet at such times and places as it or the Chairman of the Commission may fix and determine, but shall hold at least four regularly scheduled meetings a year. Special meetings may be held at the call of the Chairman of the Advisory Committee, or any three members of the Committee, or at the call of the Chairman of the Commission. A majority of the members shall constitute a quorum for the transaction of business.

(6) The Committee shall review the procedures, practices, and policies of the Commission and advise the Commission with respect thereto, assist in obtaining the cooperation of insurers, industry groups, and Federal and State agencies, consult with and make recommendations to the Commission with respect to carrying out the purposes of this Act, and render such advice as the Commission may, from time to time, seek. The written reports and recommendations of the Committee shall be made available by the Commission to the public.

(7) The members of the Committee shall not, by reason of such membership, be deemed to be employees of the United States, and such members, except the Special Assistant to the President on Consumer Affairs and the representatives of the Secretary of the Treasury and of the Secretary of Housing and Urban Development, shall receive for their services as members the per diem equivalent to the rate for grade GS-18 of the General Schedule under section 5332 of title 5, United States Code, when engaged in the performance of their duties, and each member of the Committee shall be allowed travel expenses, including per diem in lieu of subsistence, as authorized by section 5708 of such title for persons in the Government service employed intermittently.

(8) The Committee shall be subject to the Federal Advisory Committee Act.

(e) The Commission shall administer its affairs fairly and impartially and without discrimination. The Commission shall determine and prescribe the manner in which its obligations shall be incurred and its expenses allowed and paid. The Commission, with the consent of any Federal executive department, commission, independent establishment, corporation owned or controlled by the United States, board, bureau, division, service office, authority or administration in the executive branch of Government, including any field service thereof, may avail itself of the use of information, services, and facilities thereof in carrying out the provisions of this Act.

(f) (1) There are transferred to the Commission all functions, powers, and duties conferred upon the Secretary of Housing and Urban Development pursuant to title XI of the National Housing Act, title XIII of the Housing and Urban Development Act of 1968, the Flood Disaster Protection Act of 1973 and the Federal Flood Insurance Act of 1968, except that the National Insurance Development Fund shall be kept separate from the fund established under section 4. Any reference to the Secretary of Housing and Urban Development contained in any such statute shall be deemed to be a reference to the Commission.

(2) Section 5315 (91) of title 5, United States Code, is repealed.

(3) The personnel employed in connection with, and the assets, liabilities, contracts, property, records, and unexpended balances of appropriations, authorizations, allocations, or other funds held, used, arising from, or available or to be made available in connection with, the functions, powers, and duties transferred by this subsection are hereby transferred with such functions, powers, and duties, respectively.

(4) No cause of action by or against any agency whose functions are transferred by this title, or by or against an officer of any agency in his official capacity, shall abate by reason of this transfer. Such causes of action may be asserted by or against the United States, the Commission, or such officer or employee of the Corporation as may be appropriate.

(5) No suit, action, or other proceeding commenced by or against any agency whose functions are transferred by this subsection, or by or against any officer of any such agency in his official capacity, shall abate by reason of the enactment of this subsection. A court may at any time during the pendency of the litigation, on its own motion or that of any party, order that the same may be maintained by or against the United States, the Commission, or such officer or employee of the Corporation as may be appropriate.

(f) Except as may be otherwise expressly provided in this Act, all powers and authorities conferred by this Act shall be cumulative and additional to and not in derogation of any powers and authorities otherwise existing. All rules, regulations, orders, authorizations, delegations, or other actions duly issued, made, or taken by or pursuant to applicable law, prior to the effective date of this Act, by any agency, officer, or office pertaining to any functions, powers, and duties transferred by this Act shall continue in full force and effect after the effective date of this Act unless and until modified or rescinded by the Commission.

(g) The Commission shall annually make a report of its operations to the Congress as soon as practicable after the 1st day of June in each year. Such report shall include a statement with respect to the status and scope of the Federal Insurance Guaranty Fund, together with such recommendations concerning its adequacy or inadequacy as the Commission deems necessary or desirable.

FEDERAL INSURANCE GUARANTY FUND

Sec. 102. (a) The Congress finds and declares that, in order to assure policyholders the protection of insurance policies they have purchased, notwithstanding the insolvency of the issuing insurance company, the United States national policy shall be to facilitate early detection of the financial condition of insurers which, if not corrected, render reasonably probable the insolvency, impairment, or inability of such insurers to fulfill their contractual obligations to policyholders or claimants when due, and to provide for the orderly winding down and liquidation of insolvent insurers by establishing a Federal insurance guaranty program which shall establish uniform standards for guaranty status and shall maximize the efficient utilization of the capabilities and facilities of private insurers in the discharge of policy obligations of private insurers which become insolvent.

(b) There is established in the Treasury of the United States a fund to be known as the Federal Insurance Guaranty Fund (hereinafter referred to as the "fund"). The fund shall contain fees paid by companies whose insurance obligations are guaranteed by the Commission, the proceeds of obligations issued under subsection (d), and receipts from any other source.

(c) Moneys in the fund shall be available to the Commission, without fiscal year limitation, to the extent provided in appropriations Acts, for the purpose of carrying out its obligations under guaranties under this Act and to cover the expenses of carrying out its functions under this Act.

(d) To the extent necessary to cover losses, the Commission is authorized to issue to the Secretary of the Treasury notes or other obligations in an aggregate amount of not to exceed such amounts as may be approved in appropriations Acts, in such forms and denominations, bearing such maturities, and subject to such terms and conditions, as may be prescribed by the Secretary of the Treasury. Such notes or other obligations shall bear interest at a rate determined by the Secretary of the Treasury, taking into consideration the current average market yield on outstanding marketable obligations of the United States of comparable maturities during the month preceding the issuance of the notes or other obligations. The Secretary of the Treasury is authorized to purchase any notes and other obligations issued hereunder and for that purpose he is authorized to use as a public debt transaction the proceeds from the sale of any securities issued under the Second Liberty Bond Act, and the purposes for which securities may be issued under that Act are extended to include any purchase of such notes and obligations. The Secretary of the Treasury may at any time sell any of the notes or other obligations acquired by him under this subsection. All redemptions, purchases, and sales by the Secretary of the Treasury of such notes or other obligations shall be treated as public debt transactions of the United States.

(e) Any insurance obligation incurred or maintained, exclusive of the reinsured obligations of a ceding insurer by a federally guaranteed insurer during a period when such insurer is authorized to do business under this Act is guaranteed and, upon the default of such insurer, such obligation shall be met by the Commission utilizing proceeds contained in the Federal Insurance Guaranty Fund. Any guaranty hereunder is a full faith and credit obligation of the United States. The Commission shall establish and collect from each insurer guaranteed under this Act an annual fee calculated as a percentage of its net direct premiums, and such fee may not exceed one-fourth of 1 per centum per year. The Commission may establish different levels of fees for different types of insurers:

Provided, That all insurers of the same type shall pay comparable fees and the fees charged each type of company shall be reasonably related to expected losses. In establishing the guaranty fees to be collected pursuant to this Act, the Commission shall attempt to develop and maintain a balance in the Guaranty Fund sufficient to render unlikely any need to borrow from the Secretary of the Treasury. When the balance in the fund reaches such a sufficient level, the fee established and collected under this section may be reduced or suspended.

(f) The Commission shall, to the maximum extent practicable, pay any amount owing under any such guaranty through other insurers to which the policy giving rise to the obligation has been assigned.

FEDERAL GUARANTY CERTIFICATE

Sec. 108. (a) The Commission is authorized to issue a Federal guaranty certificate to any insurer which meets such financial and other requirements as the Commission may reasonably prescribe pursuant to this section.

(b) Any insurer may make application to the Commission for a certificate under this section, which certificate is in force in any line of insurance insuring persons or risks situated in any State, except that no insurer chartered under the provisions of this Act may make, issue, renew, or continue in effect any insurance policy or otherwise transact insurance unless and until it has received a certificate hereunder.

(c) Such application shall be in such form and shall contain such information as the Commission shall, by regulation prescribe, including, but not limiting to—

(1) a designation of each State in which the insurer will transact insurance and the lines of insurance to be offered ;

(2) a statement of the insurer's capital and surplus, in the case of a stock insurer, or guaranty fund, in the case of an insurer other than a stock insurer.

(d) The Commission shall make such examination of an applicant for a certificate hereunder as it deems necessary to ascertain the financial condition and fitness of the applicant. For this purpose, the Corporation may utilize employees of the Commission, independent contractors, and other agencies of the Federal Government. It may take into consideration reports of independent auditors and reports and certifications by State supervisory authorities.

(e) Any person exercising or possessing effective control of a federally guaranteed insurer shall be subject to the regulatory authority of the Commission.

(f) No insurer whose policyholders are liable to assessment under any policy issued by it shall be granted a guaranty certificate under the provisions of this Act.

(g) Nothing in this Act shall be deemed to prohibit any insurer from engaging in both a life and property and liability insurance business in any State if otherwise authorized to do so.

(b)(1)(A) Unless the application or any part thereof is earlier returned to the applicant by the Commission because of legal insufficiency, the nature of such insufficiency having been stated in writing by the Commission, the Commission shall, not later than ninety days following the filing of the application for a Federal certificate, issue or refuse to issue such certificate: *Provided*, That if a financial examination or audit of the applicant or any affiliated or related person subject to this Act has been commenced by the Commission but has not been completed, the Commission may extend the period for one additional period of ninety days.

(B) The Commission may refuse to issue a certificate hereunder upon its determination that the insurer is not financially safe and sound for any, or any combination, of the following reasons :

(i) assets supportive of the insurer's policyholder obligations fail to provide sufficient integrity and stability for that purpose ;

(ii) the insurer's underwriting commitments have consistently been in excess of its capacity ;

(iii) in applying for the certificate, the insurer has failed to disclose material facts or circumstances bearing upon its worthiness for receiving a certificate ;

(iv) the insurer's reserves for liabilities are materially deficient or its liabilities are materially understated ; or

(v) the insurer is effectively controlled by officers, directors, stockholders, or other persons whose conduct has demonstrated such persons to be unworthy of trust or confidence.

Any refusal to issue a certificate hereunder shall be by a written order issued by the Commission, which order shall specify the factual conclusions and legal authority on which the refusal is based.

(2) At any time within the ninety-day period or extension specified in paragraph (1)(A) of this subsection, the Commission may, upon notice of not less than ten days, hold a hearing in the manner provided in section 206(f) not less than thirty days nor more than ninety days after such notice inquiring into the financial condition of such applicant or any affiliated or related person or upon the fitness of such applicant to receive a certificate, and notice of such hearing shall stay the running of the time specified in paragraph (1). Such notice shall specify explicitly the matters to be considered and the persons to be examined at such hearing. Failure of the applicant or any affiliated or related person to whom notice was provided to appear at such hearing may be deemed to be an abandonment of the application for a certificate.

(1)(1) The Commission may revoke or suspend a certificate granted hereunder—

(A) upon the request of the federally guaranteed insurer;

(B) because of the insurer's willful or persistent violation of law or regulation; or

(C) for any reason which, had it existed or been known, would have justified the Commission's refusal to issue the certificate originally.

(2) A revocation or suspension of a certificate shall be effected by a written order issued by the Commission, and served upon the federally guaranteed insurer, which order shall set forth the factual conclusions and legal authority upon which the revocation or suspension is based.

(3) The Corporation shall give any federally guaranteed insurer thirty days written notice of its intention to revoke or suspend its certificate and provide an opportunity to correct the deficiencies in its operation which are stated in the notice as grounds for revocation or suspension. Any federally guaranteed insurer, prior to or after revocation or suspension of its certificate, shall, upon request, be granted an opportunity for a hearing, which shall be conducted in accord with the provisions set forth in section 206(f), to contest such decision.

(4)(A) Upon the revocation or suspension of a certificate as provided herein, or upon its surrender by a federally guaranteed insurer, all policy obligations of the insurer on policies issued or renewed while the license was in force shall cease to be guaranteed on the earliest of the following dates:

(i) the next renewal date;

(ii) the policy anniversary date;

(iii) the effective date of cancellation of the policy; or

(iv) one year from the effective date of the revocation, suspension, or surrender of the Federal guaranty certificate.

(B) The policyholder of any policy guaranteed hereunder shall be given written notice not less than sixty days prior to the loss of guaranty status on its policy.

(j) (201) Investments of a federally guaranteed insurer, other than an insurer chartered under section 201, shall be regulated, in general, by the laws and regulations of such insurer's State of domicile and the laws and regulations of the States in which it transacts insurance unless the Commission shall determine, after hearing, that the laws or regulations of such State or States fail to require that the minimum policyholders' surplus and reserve liabilities, including the loss reserves, unearned premium reserve, and mortality and morbidity reserve, of such insurer be covered, to a reasonable degree, by admissible assets of sufficient integrity and stability, or that any such insurer is not required to comply with, and does not comply with, the current investment laws or regulations of its State of domicile. Upon making such finding, the Commission shall issue such order as is necessary to bring the insurer's investments into compliance with the standards established by this section within a reasonable length of time or to terminate its status as a federally guaranteed insurer for its failure to do so. For the purpose of carrying out its functions under this section, the Commission is authorized to issue a subpoena requiring the insolvent insurer to furnish such books, records, or other materials as it deems necessary, and in the event of a refusal to comply therewith, the Commission may invoke the aid of any United States district court having jurisdiction of a district in which the insurer can be found. Refusal of insurer to obey any court order issued pursuant to any proceeding hereunder may be punished by the court as a contempt thereof.

(k) A federally guaranteed insurer shall be exempt from the provisions of

the laws of any State which require the participation of insurers in any State insolvency guaranty plan whereby such insurers are required to assume obligations of other insurers in the event of the insolvency or other financial impairment of such other insurers.

SATISFACTION OF GUARANTEED OBLIGATIONS

SEC. 104. (a) Whenever any federally guaranteed insurer has been adjudicated an insolvent insurer, the Commission shall, through its own facilities, through the facilities of a State supervisory authority or through the facilities of independent contractors retained by the Commission, satisfy all valid guaranteed obligations in the following manner:

(1) The Commission shall investigate, examine, adjust, compromise, or settle all claims arising from guaranteed obligations as quickly as possible in order to provide the public the insurance protection that would have been available but for the liquidation.

(2) Any defense against any claim under this section which was available to the insolvent insurer shall be available to the Commission.

(3) The Commission is authorized to defend any action pending or brought against the policyholder or the insured of the insolvent federally guaranteed insurer for an insurable event occurring before or fifteen days after the date of issuance of the liquidation order.

(b) The Commission shall be entitled to any valid claim against the liquidator up to an amount equal to the liabilities of such insurer paid by the Commission plus the expenses of discharging the federally guaranteed insurer's obligations under guaranteed policies. Payment of such claim shall follow the normal order of distribution of the liquidation laws of the State.

(c) The Commission shall, to the maximum extent practicable, pay any valid guaranteed claim through other insurers to which the policies giving rise to the claim have been assigned.

PROCEDURES TO AVOID DEFAULT OR TO FACILITATE THE MERGER OR CONSOLIDATION OF A FEDERALLY GUARANTEED INSURER

SEC. 105. (a) Whenever in the judgment of the Commission, such action will reduce the risk or avert a threatened loss to the Federal Insurance Guaranty Fund and will facilitate a merger or consolidation of a federally guaranteed insurer with another such insurer, or will facilitate the sale of the assets of the insurer to and the assumption of its liabilities by another such insurer, or will help to avoid the default of such an insurer, the Commission may, upon such terms and conditions as it may prescribe, make loans secured in whole or in part by assets of such insurer, which loans may be subordinated to the rights of policyholders and other creditors, or the Commission may purchase any such assets or guarantee any other such insurer against loss by reason of its assuming the liabilities in purchasing the assets of such insurer. Any such insurer or the receiver thereof is authorized to contract for such sales or loans and to pledge any such assets to secure such loans.

(b) Any agreement entered into by a federally guaranteed insurer which tends to diminish or defeat the right, title, or interest of the Commission in any asset acquired by it under this section either as security for a loan or by purchase shall be valid against the Commission only if such agreement—

(1) is in writing;

(2) was executed by the insurer and the person claiming an interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the insurer;

(3) was approved by the board of directors of the insurer which approval must be reflected in the minutes of such board; and

(4) was continuously, from the time of its execution, an official record of the insurer.

PROCEDURES FOR REHABILITATION, REORGANIZATION, OR DISSOLUTION OF A FEDERALLY GUARANTEED INSURER

SEC. 106. (a) The Commission may institute proceedings under this section to provide for the rehabilitation, reorganization, or dissolution of a federally guaranteed insurer whenever it determines that the insurer is unable, or is reason-

ably likely to become unable, to fulfill its obligations when due. Upon such determination, the Commission may, after notice to the federally guaranteed insurer, apply to the appropriate United States district court for its appointment as a receiver to administer the affairs of the insurer with respect to which the determination was made. If within three business days after the filing of an application under this section, or such other period as the court may order, the federally guaranteed insurer consents to the appointment of a receiver or fails to show why a receiver should not be appointed, the court may grant the application and appoint a receiver to administer the affairs of the insurer in accordance with the provisions of this Act and the charter of the insurer, except that the United States district court may immediately appoint a receiver upon the request of the Commission when the court finds that such action is necessary to preserve the financial integrity of the insurer, but any such insurer may request a hearing, upon a petition filed with the court not later than three days after such an appointment, with respect to such appointment.

(b) Any receiver appointed under this section shall be subject to the same duties as a trustee appointed under section 47 of the Bankruptcy Act, and shall conduct its business and the affairs of the insurer consistent with the provisions applicable to a proceeding under chapter X of the Bankruptcy Act, except that claims of policyholders which arose prior to the insurer's default shall have a priority over all other claims.

(c) If the Commission has issued a notice under this section to an insurer chartered under section 201 of this Act, and has determined at any time thereafter that the charter of that insurer should be revoked, it may, after notice to the insurer, apply to the appropriate United States district court for a decree adjudicating that the charter must be revoked in order to protect the interests of the policyholders or to avoid any further increase in the liability of the Federal Insurance Guaranty Fund. If any receiver appointed under subsection (a) disagrees with the determination of the Commission under the preceding sentence, it may intervene in the proceeding relating to the application for the to the insurer, apply to the appropriate United State district court for a decree itself. Upon the issuance of such a decree, the court shall authorize the receiver (or appoint a receiver and so authorize him, if necessary), to wind up the affairs of the insurer in accordance with the provisions of this section. If the receiver and the Commission agree that the affairs of the insurer should be wound up and the charter surrendered and to the appointment of a receiver without proceedings pursuant to this section (other than this sentence), the receiver shall have the power to take such actions as may be necessary to wind up the affairs of the insurer promptly.

REGULATORY AUTHORITY

Sec. 107. (a) In order to insure the financial stability of federally guaranteed insurers, the Commission is authorized to prescribe such rules and regulations as may be necessary to carry out its responsibilities under the provisions of this Act. Such rules and regulations shall require that—

(1) each such insurer shall pay the guaranty fee established by the Commission under section 102 of this Act or any other applicable fee or charge provided by law or regulation;

(2) each such insurer shall compute and maintain its reserve liabilities as the Commission may, from time to time, provide by regulation;

(3) each such insurer shall not sell, transfer, assign, pledge, or otherwise dispose of or relinquish control over more than 25 per centum of its funds, assets, or investments within any twelve-month period except as provided by regulation unless at least thirty days' prior notice has been provided to the Commission and it has not disapproved;

(4) each such insurer shall furnish to the Commission such files, books, reports, documents, or other records of the insurer or any affiliated or related entity as the Commission shall prescribe and shall make available to the Commission at such times and places as the Commission shall reasonably prescribe every such file, book, report, document, or other record for inspection, examination, or audit under the oath or affirmation of the person (s) having custody or control thereof; and

(5) each such insurer shall furnish under the oath or affirmation of its directors, or other members of its governing body, officers managers, or agents, such financial reports or records and at such times and in such de-

tall as the Commission may, from time to time, prescribe, including tapes, punched cards, or other material processed through an electronic data processing system maintained by the insurer or any affiliated or related entity.

(b) The Commission shall establish and maintain, either directly and solely or wholly or partially by contract with State insurance regulatory authorities or officials or an association made up of such authorities or officials, or with other appropriate organizations or associations, and "early warning system" meaning a system for the early detection of financial conditions of insurers which if not corrected render reasonably probable the insolvency, impairment, or inability of the insurer to fulfill, when due, its contractual obligations to policyholders or claimants. In order to render possible comparison and to make available broad financial and statistical data, any such "early warning system" may include both federally guaranteed insurers and other insurers. Any insurer covered by such system may be required by the Commission to submit its financial reports or records including computer tapes or cards under its electronic data processing system. The system established under this subsection shall contain such criteria and the weight to be accorded such criteria as the Commission, after consultation with the National Association of Insurance Commissioners and such other groups as are considered by the Commission to have experience in these matters.

(c) It shall be unlawful for any federally guaranteed insurer to—

(1) refuse to insure any individual or group of individuals solely because of age, sex, race, religion, or national origin; and

(2) classify, or charge a rate or premium to, any individual or group of individuals with the purpose or effect of unfairly discriminating against such persons on account of age, sex, race, color, religion, or national origin: *Provided*, That such classifications or rates, or premiums shall not be unfairly discriminatory within the meaning of this provision if they can be supported by empirical evidence demonstrating that such classes, rates, or premiums are reasonably predictive of and significantly correlated to loss and expense experience.

SUPERVISORY AUTHORITY

• Sec. 108. (a) If, in the opinion of the Commission, any federally guaranteed insurer or any director, officer, employee, agent, or other person participating in the conduct of affairs of such insurer is engaging or has engaged, or if the Commission has reasonable cause to believe that the insurer or any director, officer, employee, agent, or other person participating in the conduct of such affairs is about to engage, in any practice in connection with the affairs of the insurer which violates the provisions of this Act or of the regulations promulgated under this Act, or is violating or has violated, or the Commission has reasonable cause to believe that the insurer or any director, officer, employee, agent, or other person participating in the conduct of the affairs of the insurer is about to violate a law, rule, or regulation, or any condition imposed in writing by the Commission in connection with the granting of any benefit under this Act, the Commission may issue and serve upon the insurer or such director, officer, employee, agent, or other person a notice of charges in respect thereof. The notice shall contain a statement of the facts constituting the alleged violation or practice and shall fix a time and place at which a hearing will be held to determine whether an order to cease and desist therefrom should be issued. Such hearing shall be fixed for a date not earlier than thirty days nor later than sixty days after service of notice unless an earlier or a later date is requested by the party so served and agreed to by the Commission. Failure of the party served to appear at such a hearing shall be deemed to indicate the consent of that party to issuance of the cease and desist order. In the event of such consent, or if, upon the record of any such hearing, the Commission finds that any violation or practice specified in the notice of charges has been established, the Commission may issue and serve upon the insurer, director, officer, employee, agent, or other person an order to cease and desist from any such violation or practice. Such order may, by provisions which may be mandatory or otherwise, require the insurer or its directors, officers, employees, agents or other person participating in the conduct of its affairs to cease and desist from the same, and to take affirmative action to correct the conditions resulting from any such violation or practice. An order under this subsection shall become effective at

the expiration of thirty days after service, except in the case of a cease and desist order issued upon consent which shall become effective at the time specified therein, and shall remain effective and enforceable as provided therein except to such extent as the order may be stayed, modified terminated, amended, or set aside by action of the agency or any court.

(b)(1) Whenever the Commission determines that a violation or threatened violation or practice specified in the notice of charges served under subsection (a) or the continuation thereof is likely to cause insolvency or substantial dissipation of assets or earnings of the insurer, the Commission may issue a temporary order requiring the insurer or such director, officer, employee, agent, or other person to cease and desist from any such violation or practice. Such order shall become effective upon service upon insurer or such director, officer, employee, agent or other person participating in the conduct of the affairs of such insurer and, unless set aside, limited, or suspended by a court in proceedings authorized by this subsection, shall remain effective and enforceable pending the completion of the administrative proceedings pursuant to such notice and until such time as the Commission shall dismiss the charges specified in such notice, or if a cease and desist order is issued against the insurer or such director, officer, employee, agent, or other person, until the effective date of such order. Within ten days after the insurer or any director, officer, employee, agent, or other person participating in the conduct of the affairs of such insurer has been served with a temporary cease and desist order, the insurer or such director, officer, employee, agent, or other person may apply to the United States district court or the United States court of any territory within the jurisdiction of which the principal place of business of the insurer is located, or the United States District Court for the District of Columbia, for an injunction setting aside, limiting, or suspending the enforcement, operation, or effectiveness of such order pending the completion of the administrative proceedings pursuant to the notice of charges served upon the insurer or such director, officer, employee, agent, or other person under subsection (a) of this section, and such court shall have jurisdiction to issue such injunction.

(2) In the case of a violation or threatened violation of or failure to obey a temporary cease and desist order issued pursuant to paragraph (1), the Commission may apply to the United States district court or the United States court of any territory within the jurisdiction of which the principal place of business of the insurer is located, for an injunction to enforce such order, and if the court shall determine that there has been such violation or threatened violation or failure to obey, it shall be the duty of the court to issue such injunction.

(c)(1) Whenever, in the opinion of the Commission, any director or officer of a federally guaranteed insurer has committed any violation of law, rule, or regulation or of a cease and desist order which has become final, or has engaged or participated in any unsafe or unsound practice in connection with the insurer, or has committed or engaged in any act, omission, or practice which constitutes a breach of his duty as such director or officer, and the Commission determines that the insurer has suffered or will probably suffer substantial financial loss or other damage or that the interests of its policyholders could be seriously prejudiced by reason of such violation or practice or breach of duty, and that such violation or practice or breach of duty is either one involving personal dishonesty on the part of such director or officer, or one which demonstrates his gross negligence in the operation or management of the insurer or a willful disregard for the safety or soundness of the insurer, the Commission may serve upon such director or officer a written notice of its intention to remove him from office.

(2) Whenever, in the opinion of the Commission, any director or officer of a federally guaranteed insurer, by conduct or practice with respect to any other business concern which resulted in substantial loss or other damages, has evidenced either his personal dishonesty or gross negligence in the operation or management of the business concern or a willful disregard for its safety and soundness, and, in addition, has evidenced his unfitness to continue as a director or officer, and whenever, in the opinion of the Commission, any other person participating in the conduct of the affairs of the insurer, by conduct or practice with respect to the insurer or any other business concern which resulted in substantial financial loss or other damages, has evidenced either his personal dishonesty

or his gross negligence in the operation or management of the insurer or concern or a willful disregard for its safety and soundness, and, in addition, has evidenced his unfitness to participate in the conduct of the affairs of such insurer, the Commission may serve upon such director, officer, or other person written notice of its intention to remove him from office or to prohibit his further participation in any manner in the conduct of the affairs of the insurer.

(3) The Commission may, if necessary for the protection of the insurer or the interests of its policyholders, by written notice to such effect served upon a director, officer, or other person referred to in paragraph (1), suspend him from office or prohibit him from further participation in any manner in the conduct of the affairs of the insurer. Such suspension or prohibition shall become effective upon service of such notice and, unless stayed by a court in proceedings authorized by subsection (d) of this section, shall remain in effect pending the completion of the administrative proceedings pursuant to the notice served under paragraph (1) or (2) of this subsection and until such time as the Commission shall dismiss the charges specified in such notice, or, if an order of removal or prohibition is issued against the director or officer or other person, until the effective date of any such order. Copies of any such notice shall also be served upon the corporation of which he is a director or officer or in the conduct of whose affairs he has participated. A notice of intention to remove a director, officer, or other person from office or to prohibit his participation in the conduct of the affairs of an insurer shall contain a statement of the facts constituting grounds therefor, and shall fix a time and place at which a hearing will be held thereon. Such hearing shall be fixed for a date not earlier than thirty days nor later than sixty days after the date of service of such notice, unless an earlier or a later date is set by the Commission at the request of (A) such director or officer or other person, and for good cause shown, or (B) the Attorney General of the United States. Unless such director, officer, or other person shall appear at the hearing in person or by a fully authorized representative, he shall be deemed to have consented to the issuance of an order of such removal or prohibition. In the event of such consent, or if upon the record made at any such hearing the Commission shall find that any of the grounds specified in such notice has been established, the Commission may issue such orders of suspension or removal from office, or prohibition from participation in the conduct of the affairs of the insurer, as he may deem appropriate. Any such order shall become effective at the expiration of thirty days after service upon such insurer and the director, officer, or other person concerned (except in the case of an order issued upon consent, which shall become effective at the time specified therein). Such order shall remain effective and enforceable except to such extent as it is stayed, modified, terminated, or set aside by action of the agency or a reviewing court.

(d) Within ten days after any director, officer, or other person has been suspended from office or prohibited from participation in the conduct of the affairs of an insurer under subsection (c) of this section, such director, officer, or other person may apply to the United States district court or the United States court of any territory within the jurisdiction of which the home office of the insurer is located, or the United States District Court for the District of Columbia, for a stay of such suspension or prohibition pending the completion of the administrative proceedings pursuant to the notice served upon such director, officer, or other person under subsection (c) of this section, and such court shall have jurisdiction to stay such suspension or prohibition.

(e) Any federally guaranteed insurer which violates or any officer, director, employee, agent, or other person participating in the conduct of the affairs of such an insurer who violates the terms of any order which has become final and was issued pursuant to this section, shall forfeit and pay a civil penalty of not more than \$10,000 per day for each day during which such violation continues. The Commission shall have authority to assess such a civil penalty, after giving notice and an opportunity to the insurer or officer, director, employee, agent, or other person to submit data, views, and arguments, and after giving due consideration to the appropriateness of the penalty with respect to the size or financial resources and good faith of the insurer or person charged, the gravity of the violation, and any data, views, and arguments submitted. The Commission may collect such civil penalty by agreement with the insurer or other person or by bringing an action in the appropriate United States district court, except that in any such action the insurer or other person against whom the penalty has been assessed shall have a right to a trial de novo.

(f) (1) Any hearing provided for in this section shall be held in the Federal judicial district or in the territory in which the principal place of business of the insurer is located unless the party afforded the hearing consents to a hearing in another place, and shall be conducted in a manner consistent with the provisions of chapter 5 of title 5, United States Code, except that any such hearing shall be private unless the Commission after consideration of the views of the party afforded the hearing determines that a public hearing is necessary to protect the public interest. After such hearing, and within ninety days after the Commission has notified the parties that the case has been submitted to it for final decision, it shall render its decision (which shall include findings of fact upon which its decision is predicated) and shall issue and serve upon each party to the proceeding an order or orders consistent with the provisions of this subsection. Judicial review of any such order shall be exclusively as provided in this subsection. Unless a petition for review is timely filed in a court of appeals of the United States, as provided in paragraph (2) of this subsection, and thereafter until the record in the proceeding has been filed as so provided, the Commission may at any time, upon such notice and in such manner as it shall deem proper, modify, terminate, or set aside any such order. Upon such filing of the record, the Commission may modify, terminate, or set aside any such order with permission of the court.

(2) Any party to the proceeding, or any person required by an order issued under this section to cease and desist from any of the violations or practices stated therein, may obtain a review of any order served pursuant to paragraph (1) of this subsection (other than an order issued with the consent of the insurer, director, officer, or other person, or an order issued under paragraph (1) of subsection (c) of this section) by the filing in the court of appeals of the United States for the circuit in which the home office of the insurer is located, or in the United States Court of Appeals for the District of Columbia Circuit, within thirty days after the date of service of such order, a written petition praying that the order of the Commission be modified, terminated, or set aside. A copy of such petition shall be forthwith transmitted by the clerk of the court to the Commission, and thereupon the Commission shall file in the court the record in the proceeding, as provided in section 2112 of title 28. Upon the filing of such petition, such court shall have jurisdiction, which upon the filing of the record shall except as provided in the last sentence of paragraph (1) of this subsection be exclusive, to affirm, modify, terminate, or set aside, in whole or in part, the order of the Commission. Review of such proceeding shall be had as provided in chapter 7 of title 5, United States Code. The judgment and decree of the court shall be final, subject only to review by the Supreme Court upon a writ of certiorari, as provided in section 1254 of title 28, United States Code.

(3) The commencement of proceedings for judicial review under paragraph (2) of this subsection shall not, unless specifically ordered by the court, operate as a stay of any order issued by the Commission.

(g) The Commission may apply to the United States district court or the United States court of any territory, within the jurisdiction of which the principal place of business of the insurer is located, for the enforcement of any effective and outstanding notice or order issued under this section, and such courts shall have jurisdiction and power to order and require compliance therewith; but except as otherwise provided in this section no court shall have jurisdiction to affect by injunction or otherwise the issuance or enforcement of any notice or order under this section, or to review, modify, terminate, or set aside any such notice or order.

(h) As used in this section—

(1) the terms "cease and desist order which has become final" and "order which has become final" means a cease and desist order or an order, issued by the Commission with the consent of the insurer or the director or officer or other person concerned, or with respect to which no petition for review of the action of the Commission has been filed and perfected in a court of appeals as specified in paragraph (2) of subsection (b), or with respect to which the action of the court in which said petition is so filed is not subject to further review by the Supreme Court of the United States in proceedings provided for in said paragraph, or an order issued under paragraph (1) of subsection (g) of this section; and

(2) the term "violation" includes without limitation any action (alone or with another or others) for or toward causing, bringing about, participating in, counseling, or aiding or abetting a violation.

(i) Any service required or authorized to be made by the Commission under this section may be made by registered mail, or in such other manner reasonably calculated to give actual notice as the Commission may by regulation or otherwise provide.

(j) In the course of or in connection with any proceeding under this section, the Commission, or any designated representative thereof, including any person designated to conduct any hearing under this section, shall have the power to administer oaths and affirmations, to take or cause to be taken depositions, and to issue, revoke, quash, or modify subpoenas and subpoenas duces tecum; and such Commission is empowered to make rules and regulations with respect to any such proceedings. The attendance of witnesses and the production of documents provided for in this subsection may be required from any place in any State or in any territory or other place subject to the jurisdiction of the United States at any designated place where such proceeding is being conducted. Any party to proceedings under this section may apply to the United States District Court for the District of Columbia, or the United States district court or the United States court of any territory in which such proceeding is being conducted or where the witness resides or carries on business, for enforcement of any subpoena or subpoena duces tecum issued pursuant to this subsection, and such courts shall have jurisdiction and power to order and require compliance therewith. Witnesses subpoenaed under this section shall be paid the same fees and mileage that are paid witnesses in the district courts of the United States. Any court having jurisdiction of any proceeding instituted under this section by a corporation or a director or officer thereof, may allow to any such party such reasonable expenses and attorneys' fees as it deems just and proper; and such expenses and fees shall be paid by the corporation or from its assets.

COMPETITION

SEC. 100. (a) The Commission shall not adopt any rule or regulation or exercise any other authority granted to it under this Act in such a manner as to impose a burden on competition not necessary or appropriate in furtherance of the purposes of this Act, and in all cases shall adopt the least anticompetitive alternative to protecting policyholders and the public interest.

(b) Except as provided herein, nothing contained in this Act shall affect the applicability of the antitrust laws to the business of insurance.

(c) Notwithstanding any other provision of law, the Federal antitrust laws shall be applicable to federally chartered insurers in their conduct of the business of insurance with respect to those activities that are exempt from certain State regulation as specified in section 204 of this Act. For purposes of this section, the Federal antitrust laws shall include the Sherman Antitrust Act (15 U.S.C. 1 and following), the Clayton Act (15 U.S.C. 12 and following), the Federal Trade Commission Act (15 U.S.C. 41 and following).

TITLE II—FEDERAL CHARTERING OF INSURANCE COMPANIES

CHARTERING

SEC. 201. (a) The Commission is authorized to issue a charter to any stock, mutual, or reciprocal insurer, reinsurer, or surety, the United States branch of an alien insurer or surety, or any other alien insurer or surety maintaining in the United States at all times trust funds of not less than \$50,000,000 or such lesser amount as may be approved by the Commission, for the security of policyholders and claimants in accordance with such rules, regulations, and procedures as the Commission may prescribe.

(b) (1) Notwithstanding the provisions of the law of any State, any stock, mutual, or reciprocal insurer, a Lloyds organization, or a surety, organized or incorporated under the authority of State law, having been certified by the Commission as otherwise eligible to become a federally chartered insurer and upon the majority vote of its stockholders, or in the case of a nonstock insurer, a majority of its policyholders or members, voting in person or by proxy at a meeting called for such purpose, shall be issued a Federal charter.

(2) Upon the issuance of the Federal charter—

(A) the State charter or similar other authority of organization of the insurer shall be preempted and terminated, except that any such insurer shall be deemed to continue its corporate or other existence for all purposes of Federal and State law; and

(B) the insurer shall be deemed to be authorized to do business in any State.

(3) Notwithstanding the provisions of paragraph (2), the appropriate authority of a State may, for cause and upon a showing to the satisfaction of the Commission that such action is necessary or justified, revoke the authority of a federally chartered insurer to do business in that State.

(c) Upon the issuance of such a charter, all insurance obligations of the federally chartered insurer shall be guaranteed in accordance with the provisions of title I of this Act.

(d) The Commission may, by rule, prohibit any alien insurer, other than the United States branch of an alien insurer, from transacting an insurance or surety business in any State of the United States unless such alien insurer is chartered under the provisions of this Act, but such prohibition shall not extend to reinsurance other than reinsurance under which the alien insurer assumes reinsurance in excess of a 90 per centum quota share of the ceding insurer's insurance business or any line thereof.

(e) The principal place of business of a federally chartered insurer shall be designated in its charter. The principal place of business of an existing insurer electing to obtain a Federal charter under this Act shall be deemed to be the State in which it was formerly chartered unless it designates at the time of filing its application for a charter or at any time after such a charter is issued another State with the approval of the Commission.

(f) (1) A federally chartered insurer may elect to surrender its Federal charter, together with all right, power, authority, and entitlements granted thereunder or incident thereto, upon the majority vote of its stockholder or, in the case of a nonstock insurer, the majority vote of its policyholders or members, voting in person or by proxy at a meeting called for such purpose. The notice of such meeting shall be given at least thirty days prior thereto and shall contain a certified statement of the Commission, prepared for such purpose and at the expense of the insurer, setting forth the financial condition of the insurer and its ability to meet its insurance obligations. The Commission shall prepare such certified statement within sixty days of a written request therefor from the board of directors or other similar governing body of the insurer.

(2) The election of a federally chartered insurer to surrender its Federal charter may be made upon such terms and conditions, not inconsistent with the provisions of this Act, as the vote authorizing such election may provide. The Commission shall not certify the surrender of the insurer's Federal charter and the date thereof until such terms and conditions have been met.

(g) Except as otherwise specifically provided in this Act, a federally chartered insurer shall have the powers of a business corporation chartered in the District of Columbia under the District of Columbia Business Corporation Act, and shall be subject to the provisions of such Act.

ORGANIZATION

Sec. 202. (a) (1) A federally chartered insurer may be formed by any number of persons, but in no event less than three individuals. Such persons shall transmit to the Commission verified articles of organization in such form and with such content as the Commission may prescribe, including generally, the object for which the insurer is formed, the line or lines of insurance or surety which it intends to transact and the States in which it is currently doing business or proposes to do business within the five-year period following its application for a Federal charter. Such articles of organization shall include, or be accompanied by, the articles of incorporation, charter, or constitution of the organization, the bylaws, and the biographical background of the organizers, directors, and proposed officers of the organization.

(2) The material filed with the Commission shall state the capital and surplus, in the case of a stock insurer, or guaranty fund, in the case of an insurer other than a stock insurer, which shall not be less than such amount as the Commission may, by rule, prescribe. No portion of such capital, surplus, or guaranty fund shall consist of surplus notes or any other form of direct or indirect indebtedness.

(3) In the case of a group or fleet of insurers under common management or subject to the effective control of one person, including, but not limited to, a holding company, no one or more of such insurers (other than alien insurers)

constituting such group or fleet of insurers or insurers under common management or control shall be chartered unless all shall be so chartered or a plan for such chartering is filed with the Commission for its approval.

(4) Any person exercising or possessing effective control of a federally chartered insurer shall be subject to the regulatory authority of the Commission including, but not limited to, its powers of examination and audit.

(5) No insurer whose policyholders are liable to assessment under the contract of insurance issued by it shall be chartered under the provisions of this Act.

(b) No Federal charter shall be issued in the name of an insurer whose name is identical with or so similar to the name of an insurer already licensed or authorized in one or more of the United States as reasonably likely to cause confusion or be misleading or deceptive to policyholders or claimants.

(c) Nothing in this Act is intended, nor shall it be deemed, to authorize any insurer to engage in both a life and property and liability insurance business in any State which precludes an insurer from transacting both a life and property and liability insurance business.

(d)(1) Unless the articles of organization or other documents or material filed by the applicant are earlier returned to the applicant by the Commission because of legal insufficiency, the nature of such insufficiency having been stated in writing by the Commission, the Commission shall, not later than ninety days following the filing of the application for a Federal charter, approve or disapprove the issuance of such charter, except, that if a financial examination or audit of the applicant or any affiliated or related person has been commenced by the Commission but has not been completed, the Commission may extend the period for a further period of ninety days.

(2) At any time within the ninety-day period or extension specified in paragraph (1) of this subsection, the Commission may, upon notice of not less than ten days, hold a hearing not less than thirty days nor more than ninety days after such notice inquiring into the financial condition of the applicant or any affiliated or related person or upon the fitness of such applicant to receive a Federal charter, and notice of such hearing shall stay the running of the time specified in paragraph (1) of this subsection. Such notice shall specify the matters to be considered and the persons to be interrogated at such hearing. Failure of the applicant or any affiliated or related person to whom notice was provided to appear at such hearing may be deemed to be an abandonment of the application for a Federal charter.

(e) Upon its approval of the application, the Commission shall issue a charter to the insurer whereupon the insurer shall have the power—

(1) to adopt and use a seal or insignia;

(2) to have perpetual succession until such time as it is dissolved by the act of its stockholders, policyholders, or members, or by law, or until such charter is revoked by the Commission;

(3) to enter into contracts;

(4) to sue and be sued; complain, and defend, in any court of law or equity;

(5) to elect or appoint directors or other members of its governing body, to elect or appoint officers or managers and to prescribe their duties and compensation;

(6) to prescribe through its governing body bylaws or other code of internal regulation for the conduct of its internal affairs including, but not limited to, the manner in which its shares, or other muniments of ownership, shall be transferred, its governing body elected or appointed, its officers or managers elected or appointed, its property transferred, its general business conducted, and the privileges granted it by law exercised and enjoyed;

(7) to exercise through its governing body, officers, managers, or agents all such powers and authority as may be necessary or appropriate to transacting its insurance business; and

(8) with the approval of the Commission, to conduct any other business which is complementary or incidental to the insurance business or the functions performed therein if any such other business is conducted subject to any limitations the Commission may prescribe for the protection of the interests of policyholders of the insurer, after taking into account the effect of any such other business on the insurer's existing business and its surplus, the proposed allocation of the estimated cost of any such business

and the risks inherent in any such business as well as the relative advantages to the insurer and its policyholders of conducting such business directly instead of through a subsidiary.

(f) Every insurer chartered under this Act and every person affiliated with or who effectively controls or is controlled by such insurer shall comply with such rules and regulations as the Commission may prescribe, and shall make such periodic reports in such form and in such detail as the Commission shall prescribe, and shall be subject to examination or audit by the Commission or its delegate.

COMMENCING BUSINESS

SEC. 203. (a) A federally chartered insurer may commence and continue transacting insurance only if it has a certificate under the hand and seal of the Commission certifying—

(1) that its capital and surplus or guaranty fund has been paid in;
 (2) that such capital and surplus or guaranty fund has been invested in such assets as are permitted under this Act or the Commission's regulations, or are held in such deposits or custodial accounts as prescribed by the Commission;

(3) that its reserve liabilities meet the standard prescribed by the Commission under section 107; and

(4) that the contracts of insurance or suretyship it proposes to use are in compliance with the provisions of this Act and, with the exception of laws relating to rates or premiums, that such contracts are in compliance with any applicable laws or regulations of the State or States where such contracts are proposed to be issued.

(b) Any such certificate issued by the Commission pursuant to subsection (a) of this section shall continue in effect unless revoked or suspended by the Commission.

APPLICABILITY OF STATE LAW

SEC. 204. (a) A federally chartered insurer shall be exempt from the provisions of the law of any State—

(1) which require the establishment and maintenance of reserves in the business of insurance done in that State;

(2) which require the participation of insurers in any State insolvency guaranty plan whereby such insurers are required to assume obligations of other insurers in the event of the insolvency or other financial impairment of such other insurers;

(3) which provide for the regulation of investments; or

(4) which provide for the regulation or fixing of rates or premiums or of classes of risks established by insurers operating in that State, except regulation of (A) any assigned risk plan or other residual risk market mechanism established under State law, or (B) any line of insurance (other than reinsurance) in which the Commission determines that the insurer competes principally for the producers' business rather than the business of the ultimate consumer.

(b) Nothing in this section may be construed to deny to any State the right to levy taxes or to require license fees for federally chartered insurers transacting insurance within its jurisdiction except that a federally chartered insurer has no liability to any State for a tax measured by gross premiums or net premiums collected to the extent that the amount of such tax exceeds or would exceed the amount of tax which would be imposed on the same amount of gross or net premiums of the least taxed insurer (other than a nonprofit medical or hospital-type corporation) doing the same type of business and organized under the laws of any State (other than the taxing State). Except as otherwise provided herein, a federally chartered insurer shall for tax purposes be taxed at no higher rate than a foreign insurer doing the same type of business in any State in which it is authorized to do business.

(c) For the purpose of any tax law enacted under authority of a State, a federally chartered insurer shall not be treated as an insurer organized or incorporated under the law of the enacting State. For the purpose of any other law enacted under authority of a State or any law enacted under authority of the United States, a federally chartered insurer shall be treated as an insurer organized or incorporated under the law of the State in which it has its principal place of business, as provided in its charter.

INVESTMENTS

Sec. 205. (a) The purpose of this section is to require that funds of any federally chartered insurer in an amount equal to the sum of its policyholder obligations and minimum capital and surplus, or guaranty fund required by law, shall be invested in assets of integrity and stability, and to provide that funds of such insurer in excess of those required to cover such policyholder obligations and capital and surplus or guaranty fund may be invested at the discretion of the insurer, except that such excess funds shall not be invested in assets prohibited by subsection (g).

(b) As used in this section, the term "policyholder obligations" means those liabilities of the insurer to its policyholders and claimants against such policyholders on account of insurance contracts issued by it and obligations to creditors, and includes the liabilities required to be included in the insurer's annual statement filed with insurance regulatory authorities of the State in which the insurer's principal place of business is located including, but not limited to, the unearned premium reserve, reserve required by applicable mortality or morbidity tables prescribed by the Commission, and claim or loss reserves including reserves for incurred but not reported losses and for loss adjustment expense; but "policyholder obligations" does not include that portion of the insurer's capital and surplus, or guaranty fund, in excess of the minimum capital and surplus, or guaranty fund, required by law for such insurer.

(c) For the purpose of covering its policyholder obligations and minimum capital and surplus or guaranty fund, every federally chartered insurer shall have and maintain investments of the classes described in this subsection to the extent of such policyholder obligations and minimum capital and surplus or guaranty fund less an amount equal to 30 per centum of its surplus as regards policyholders, but in no event shall such insurer have and maintain investments of the character described less than in an amount equal to the sum of 70 per centum of such policyholder obligations, other than its minimum capital and surplus or guaranty fund, and 100 per centum of the minimum required capital and surplus or guaranty fund, except that the investments referred to in this subsection shall be subject to the limitations provided by subsection (d), and the Commission shall disallow any specific investment upon its finding that such investment does not meet the standard of unquestioned integrity and stability for the purposes of this subsection:

(1) cash, cash funds and interest accrued thereon on deposit, or in savings accounts, or under certificates of deposit, or in any other form, in solvent banks or trust companies that have qualified for the insurance protection afforded by the Federal Deposit Insurance Corporation, but such cash or cash funds shall not be limited to, or by, the amount of any such insurance protection;

(2) cash, cash funds, and interest accrued thereon on deposit or in savings accounts, or under certificates of deposit, or in any other form, in solvent building and loan or savings and loan associations that have qualified for the insurance protection afforded by the Federal Deposit Insurance Corporation or Federal Savings and Loan Insurance Corporation, but such cash or cash funds shall not be limited to, or by, the amount of any such insurance protection;

(3) premiums in the course of collecting, including due and deferred premiums in the course of collection from agencies or general agencies effectively owned or controlled by, or owning or controlling the insurer, not more than ninety days past due, less commissions payable thereon, and installment premiums to the extent of the unearned premium reserve carried on the policies to which such premiums apply, less commissions payable thereon: *Provided*, That premium balances not more than ninety days past due that are due from agencies effectively owned or controlled by, or effectively owning or controlling the insurer, may be deemed assets of the insurer only to the extent that such balances due from the agency or general agency are represented by assets of the kind described in the subsection subject to the limitations mentioned in subsection (d);

(4) reinsurance recoverables not more than ninety days past due from solvent reinsurers, including deposits made with assuming reinsurers or held by ceding insurers under reinsurance agreements but only to the extent that such deposits are available as offsets against liabilities under such reinsurance agreements;

(5) bonds, notes, warrants, and other securities which are the direct obligations of the United States or for which the full faith and credit of the United States is pledged for the payment of principal and interest;

(6) obligations or stock, where stated, of the following agencies or instrumentalities of the United States, whether or not such obligations are guaranteed by the Government:

- (A) Commodity Credit Corporation;
- (B) Federal intermediate credit banks;
- (C) Federal land banks;
- (D) Central Bank for Cooperatives;
- (E) Federal home loan banks and stock thereof;
- (F) Federal National Mortgage Association, and stock thereof when acquired in connection with sale of mortgage loans to the Association;
- (G) Government National Mortgage Association; and
- (H) other agencies or instrumentalities of the United States as approved by the Commission from time to time;

(7) bonds, notes, warrants, and other securities which are the direct obligations of any State or territory of the United States or of the District of Columbia, or for which the full faith and credit of such State, territory, or District has been pledged for the payment of principal and interest;

(8) bonds, notes, warrants, and other securities that are valid and legally authorized obligations issued, assumed, or guaranteed by any county, city, town, municipality, or district of any State or territory of the United States, or by any political subdivision thereof, or by any civil division or public instrumentality of the United States, any State or territory of the United States, or any county, city, town, or district of any such State or territory, if by statutory or other legal requirements applicable thereto, such obligations are payable, both as to principal and interest, from taxes levied, or required by law to be levied, upon all taxable property or taxable income within jurisdiction of such governmental unit, or from special revenues pledged or otherwise appropriated or by law required to be appropriated for the purpose of such payment, but not including any obligations payable solely out of special assessments on properties benefited by local improvements: *Provided*, That obligations payable out of special revenues pledged or otherwise appropriated or required by law to be appropriated for the purpose of such payment, shall be eligible for purposes of this section only if such obligations are eligible for amortization in accordance with standards promulgated in rules or regulations issued by the Commission;

(9) bonds, notes, warrants, or other securities of the Dominion of Canada, or of any Province thereof;

(10) bonds, notes, or debentures of solvent corporations existing under the laws of the United States or any State or territory thereof, the District of Columbia, Canada, or any Province thereof, if such obligations meet such standards of integrity and stability as the Commission may from time to time prescribe;

(11) preferred or guaranteed stocks or shares, other than common stocks, of solvent institutions existing under the laws of the United States or of any State, or territory thereof, or of the District of Columbia, if such obligations meet such standards of unquestioned integrity and stability as the Commission may from time to time prescribe;

(12) if a life insurer, as loans to policyholders upon pledge of the policy as collateral security, amounts not exceeding the cash surrender values of such policies;

(13) if a life insurer, bonds or evidences of debt secured by first mortgages or deeds of trust on improved unencumbered real property or the equity of the seller of any such property in the contract for a deed covering the entire balance due on a bona fide sale of such property located in the United States or any State or territory thereof or the District of Columbia; but no such mortgage loan or investment in the equity of the seller in the contract for deed shall exceed in amount at the time of acquisition 75 per centum of the fair market value of the property. Real estate shall not be deemed to be encumbered within the meaning of this paragraph (13) by reason of the existence of taxes or assessments which are not delinquent, instruments creating or reserving mineral, oil, or timber rights, rights-of-ways, joint driveways, sewer rights, rights in walls, nor by reason of building restrictions or other restrictive covenants, nor when such real estate is subject

to lease in whole or in part whereby rents or profits are reserved to the owner if in any event the security for the loan or investment is a first lien upon the real estate: *Provided, however,* That the value of any mineral, oil, timber, or similar right so reserved shall not be included in the fair market value of the property;

(14) if a life insurer, bonds or notes secured by mortgage or trust deed guaranteed or insured as to principal in whole or in part under chapter 37 of title 38, United States Code, or bonds or notes secured by mortgage or trust deed guaranteed or insured under the National Housing Act; and

(15) common stocks of any solvent corporation incorporated under the laws of the United States or any State or territory thereof or the District of Columbia or the Dominion of Canada or any Province thereof, if the stocks of such corporation are listed or admitted to trading on a national securities exchange located in the United States and registered pursuant to section 6 and 19 of the Securities Exchange Act of 1934.

(d) Investments made by federally chartered insurers for the purpose of covering their policyholder obligations and their minimum capital and surplus or guaranty fund provided by law, as provided in subsection (c), are, with respect to such purpose only, subject to the following limitations;

(1) None of the securities mentioned in subdivision (c) shall be eligible for the purposes of that subsection if, within the five years immediately preceding, the obligor shall have defaulted in the payment of principal or interest on any of its bonds, warrants, or other securities.

(2) In respect to investments of the kind described in paragraph (8) of subsection (c) not more than an amount equal to 10 per centum of the insurer's policyholders' obligations shall be invested in the securities of any one such county, city, town, village, municipality, or district of such State or territory of the United States or of any political subdivision thereof, or of any such civil division or public instrumentality.

(3) Investments of the kind described in paragraph (9) of subsection (c) shall not exceed an amount equal to 5 per centum of the insurer's policyholder obligations.

(4) Investments of the kind described in paragraph (10) of subsection (c) shall not exceed an amount equal to 40 per centum of the insurer's policyholder obligations, nor shall more than an amount equal to 5 per centum of the insurer's policyholder obligations be invested in any one such investment.

(5) Investments of the kind described in paragraph (11) of subsection (c) shall not exceed an amount equal to 10 per centum of the insurer's policyholder obligations.

(6) Investments of the kinds described in paragraphs (13) and (14) of subsection (c) shall not exceed in the aggregate an amount equal to 40 per centum of the insurer's policyholder obligations, nor, with respect to investments under any of such paragraphs shall more than an amount equal to 5 per centum of the insurer's policyholder obligations be invested in any one such investment or in any one project, subdivision, or series of related transactions thereunder as determined by the Commission.

(7) Investments of the kind described in paragraph (15) of subsection (c) shall not exceed an amount equal to 10 per centum of the insurer's policyholder obligations.

(8) For the purposes of the limitations contained in this subsection (d), the property and securities enumerated in subsection (c) shall be valued at market value or at cost, less depreciation except that the Commission may, by regulation, authorize valuation of securities in accordance with stated values established for such securities in writing or as published by the Committee on Valuation of Securities of the National Association of Insurance Commissioners.

(e) A federally chartered insurer owning not less than 80 per centum of all classes of the outstanding stock of one or more federally chartered insurers may, for the purpose of complying with subsection (c) of this section, as limited by subsection (d), so comply on the basis of a consolidated statement

(f) Any federally chartered insurer not in compliance with the requirements imposed by this section shall within a reasonable time, not to exceed thirty days, notify the Commission of that fact. Upon being so notified, or upon otherwise determining such fact, the Commission shall forthwith order the federally chartered insurer to make good the deficiency within thirty days, and it shall upon a

failure of such insurer to make good the deficiency within that period, revoke or suspend the Federal charter of such insurer until the deficiency has been made good: *Provided, however,* That if such noncompliance involuntarily results from the acquisition of the property or security through foreclosure or otherwise results from a default in a loan or other obligation and such acquisition was rendered necessary in order to protect the investment or avoid greater loss, the Commission may further extend such period if the federally chartered insurer establishes that such extension is necessary, that it will not unduly prejudice the policyholders, and that the insurer has, in good faith, entered upon a course of action calculated to terminate such noncompliance on or before the expiration of such extended period.

(g) Notwithstanding any other provision of this section, no federally chartered insurer shall invest any of its funds in or lend any of its funds upon the security of—

(1) issued shares of its own capital stock except with the written permission of the Commission which may be granted at its discretion where the purpose of such acquisition is in connection with a lawful plan for mutualization of the insurer or in furtherance of a retirement, pension, or incentive program for officers or employees of the insurer, which plan has been approved by the stockholders, or if such acquisition is shown otherwise to be for the benefit of all stockholders; but in no event shall such shares so acquired be admissible as an asset covering policyholder obligations;

(2) securities issued by a corporation which is insolvent at the time of the proposed investment except with the written consent of the Commission pursuant to its determination that such proposed acquisition is pursuant to a reorganization or rearrangement in bankruptcy or some similar proceeding or that such acquisition will not be prejudicial to stockholders, policyholders, or creditors, but no such securities shall be used to cover policyholder obligations;

(3) securities which will subject the insurer to any assessment other than for taxes or wages; or

(4) any investment or security which is found by the Commission to be designed to evade any prohibition of this subsection.

(h) The assets enumerated in subsection (c) and other assets not prohibited under subsection (g) nor required to be scheduled as nonadmitted assets in any annual statement form as prescribed from time to time by the Commission, shall be deemed admitted assets for purposes of determining the solvency or solidity of the federally chartered insurer or any applicant for a Federal charter, and all such assets shall be valued in accordance with the standards prescribed in paragraph (8) of subsection (d).

REMARKS OF SENATOR BROOKE ON INTRODUCTION OF S. 1710

[Reprinted from the Congressional Record, June 16, 1977]

By Mr. BROOKE:

S. 1710. A bill to authorize the issuance of charters or carrying on the business of insurance, to provide for the guarantee of the insurance obligations, and for other purposes; to the Committee on Banking, Housing and Urban Affairs.

Mr. BROOKE. Mr. President, on October 1, 1976, the day of sine die adjournment of the 94th Congress, I introduced S. 3884, titled the Federal Insurance Act of 1976. At that time, I stated that I was introducing the bill so that it would be in the public domain, available for discussion and comment by those who are interested in the future of our insurance industry.

The bill was not offered as a definitive piece, but as a working document to be studied and criticized. And I continue to view the concepts which are included in the bill I am introducing today in the same way.

Since I introduced S. 3884, I have had an opportunity to meet with a number of insurance executives, insurance agents, and some State regulators. And the discussions which I have had with them have led me to modify the provisions of S. 3884. No doubt this legislation will be further modified as comments are received on the version of the bill which I introduce today.

The bill grew out of my concern about the financial condition of the property casualty insurance business. In 1974 and 1975, property casualty companies experienced the 2 worst years in their history, with combined underwriting

losses totaling \$7 billion for the 2 years. And there was considerable concern at that time that one or more major insurance companies would be declared insolvent. A year ago newspaper headlines were speculating on the possibility of the failure of the Government Employees Insurance Co.—GEICO—and the effect of such a failure on the policyholders of that company. The New York Times on June 11 of last year reported that—

The consensus is that the already strained (guaranty fund) pools could not handle the intense claim activity of a GEICO portfolio.

The weakened financial condition of the property casualty industry and the possibility of a major company failure prompted me to consider what steps might be taken to insure protection for policyholders and to improve the quality of regulation for solvency.

Since last year the outlook for the property casualty industry has improved. Preliminary figures for 1976 indicate that underwriting losses have declined to a level of \$2.2 billion, and the GEICO situation appears to have been turned around. But the mere fact that \$2.2 billion in underwriting losses can be regarded as an improvement shows how deeply troubled the property casualty industry has been, and still is. Of course, I hope that the worst is over and that the industry will make a strong recovery. But the trauma of the last few years has brought home to me the need to improve the protections available to insurance policyholders before the next brush with disaster.

The May 25, 1977, issue of the Washington Post carries a story entitled, "How an Insolvent Firm Keeps Selling Insurance." I am submitting this article for inclusion in the Record following the text of the bill which I introduce today. The facts which this article narrates, I believe, provide further evidence of the need to upgrade the quality of solvency regulation in the insurance industry.

Presently, the policyholder obligations of insurance companies are protected by a system of State insurance guaranty funds which were set up in the late 1960's and early 1970's, after a spate of insurance company bankruptcies left insurance companies without insurance protection. These guaranty funds are designed to provide for the payment of claims against covered individuals when their insurer fails, and since 1969 these funds have disbursed about \$104 million in 106 insurance company insolvencies. However, the funds have yet to face the collapse of a major insurer, and most knowledgeable observers question their ability to do so. Furthermore, while 46 States have guaranty funds to protect against the failure of property casualty companies, only 18 States presently offer guaranty fund protection against a life insurance company insolvency.

Since each State runs its own guaranty fund, the effort to prevent or control insolvencies is fragmented and ineffective. Uniform standards for guaranty status have not been developed by the States, and the prospect of a number of States scrambling to secure control of the assets of a failed insurer to meet policyholder obligations within their jurisdictions does not present a pretty picture.

Assessments to pay for insolvencies are made after the fact, and they are levied at a time when many companies have troubles of their own, which may be aggravated by the necessity of paying an assessment, thus posing the threat of a domino effect. This threat is somewhat mitigated by the fact that assessments are limited by statute to about 1 percent of a company's premium volume in about half the States and 2 percent in the rest, but this very limitation means that most funds would not be able to deal with a major failure or multiple failures in a timely fashion.

Where State guaranty funds have been operated on a "preassessment" basis, they have proven to be subject to the whims of the State legislature. New York State's fund amassed \$240 million through assessments and interest income. However, to help alleviate New York State's fiscal crisis, the New York State Property and Liability Insurance Security Fund switched more than \$200 million from bank certificates of deposit and Federal Government securities into New York State obligations. Thus, the New York State fund was illiquid just at the time when it was most likely to be called upon to deal with an insurance company insolvency.

These and other weaknesses in our present system for dealing with insurance company insolvencies have convinced me that it would be desirable to create an alternative system of regulation for solvency purposes.

The bill which I introduce today would seek to improve the quality of insurance company regulation by providing for an alternative system of Federal regulation

similar to the Federal regulatory alternative presently available to banks and savings and loan associations under what has come to be known as the "dual banking system." I believe that the existence of such a system of alternative regulation would provide a check against both inadequate regulation and over-regulation at either the State level or the Federal level.

The bill consists of two titles. Title I would create a Federal insurance guaranty program similar in concept to the Federal Deposit Insurance program available in the banking field. Title II provides a Federal chartering alternative for insurance companies similar to the Federal chartering alternative presently available to banks and savings and loan associations under the dual banking system.

TITLE I—FEDERAL INSURANCE GUARANTY PROGRAM

Section 101 of the bill would establish a Federal Insurance Commission which would be an independent agency in the executive branch of the Federal Government and would be charged with the administration of both the Federal insurance guaranty program described in title I and the Federal chartering alternative described in title II. The Commission would consist of three members appointed by the President and confirmed by the Senate, and each member would serve for a term of 6 years. The Chairman would be designated by the President, and executive authority within the Commission would be vested in the Chairman.

All of the functions presently administered by the Federal Insurance Administrator at the Department of Housing and Urban Development would be transferred to the Commission, and the Commission would be vested with rule-making and other powers necessary to carry out its responsibilities.

Section 101 would also create an advisory committee to the Federal Insurance Commission which would consist of consumer and industry representatives, as well as representatives of State regulatory agencies and representatives of the Treasury Department and the Department of Housing and Urban Development.

Section 102 would create a Federal Insurance Guaranty Fund which would consist of fees paid by insurance companies whose obligations are guaranteed by the Federal Insurance Commission. This fund would be authorized to borrow from the Secretary of the Treasury such amounts as are necessary to cover losses which might arise during the early years of operation of the fund or in a crisis situation. However, the fund is expected to operate on a self-sustaining basis, and moneys borrowed from the Treasury would have to be repaid. An annual fee of not to exceed one-fourth of 1 percent per year would be assessed against federally guaranteed insurers.

Under section 103, the Federal Insurance Commission would be authorized to issue a Federal guaranty certificate to any insurer, whether State-chartered or federally-chartered, which meets such financial and other requirements as the Commission may prescribe. The Commission may for cause deny a Federal guaranty certificate to an applicant or may revoke or suspend such certificate, but in taking such action, the Commission would be required to issue a written order specifying the factual conclusions and legal authority on which its action is based.

Section 103 also provides that investments of a federally-guaranteed insurer, other than a federally-chartered insurer, would be regulated in general by the laws and regulations of the insurer's State of domicile, unless the Commission finds that such laws or regulations fail to require the minimal protections necessary for the Federal Insurance Fund, in which case the Commission may issue an order requiring that the insurer bring its investments in compliance with the standards established by the Commission.

A federally-guaranteed insurer would, under the provisions of section 103, be exempt from State insurance guaranty fund assessments.

Section 104 provides that whenever a federally-guaranteed insurer is adjudicated to be insolvent, the Federal Insurance Commission shall satisfy all guaranteed obligations. A "guaranteed obligation" is defined as: First, an insurance obligation to a policyholder, a claimant of an insured, or an assignee of any of them, within the coverage of a policy guaranteed in accordance with the bill; or second, the right of a policyholder, an insured, or the assignee of either of them, for returns of premium due as the result of termination of a policy guaranteed in accordance with the provisions of the bill by reason of an insolvency arising while the insurer is a federally-guaranteed insurer.

Section 105 prescribes procedures available to the Commission to avoid default or to facilitate the merger or consolidation of a federally-guaranteed insurer.

Section 106 describes the procedures available to the Commission for the rehabilitation, reorganization, or dissolution of a federally-guaranteed insurer. The Commission may, after notice to the federally-guaranteed insurer, apply to the appropriate U.S. district court for the appointment of a receiver to administer the affairs of an insurer which is either unable, or reasonably likely to become unable, to fulfill its obligations when due.

Any receiver appointed would be subject to the same duties as a trustee under section 47 of the Bankruptcy Act and would conduct the insurance company's affairs consistent with the provisions applicable to a proceeding of chapter X of the Bankruptcy Act.

Section 107 describes the regulatory authority of the Commission, including authority to establish an "early warning system" to help prevent insolvencies. Such an "early warning system" could be developed either by the Commission itself or by the Commission in cooperation with State regulatory authorities and trade associations.

Section 107 further provides that it would be unlawful for any federally-chartered insurer to refuse to insure any individual or group of individuals solely because of age, sex, race, religion, or national origin, and to classify or charge a rate or premium to such individual or group of individuals with the purpose or effect of unfairly discriminating against them.

Section 108 sets forth the supervisory authority of the Federal Insurance Commission over federally-guaranteed companies. The powers given to the Federal Insurance Commission under this section are parallel to the authorities granted to the Federal Deposit Insurance Corporation in its supervision of federally-insured banks.

Section 109 provides that the Commission shall not adopt any rule or regulation or exercise its authority in such a manner as to impose a burden on competition not necessary or appropriate in the furtherance of the purposes of the bill, and that the Commission shall in all cases adopt the least anticompetitive alternative to protecting policyholders and the public interest. With respect to federally-chartered insurers, this section makes clear that the Federal antitrust laws would be applicable to them. Of course, the bill does not amend the McCarran-Ferguson Act, and State-chartered, federally-guaranteed companies would maintain their current posture vis-a-vis of the Federal antitrust laws.

TITLE II—FEDERAL CHARTERING OF INSURANCE COMPANIES

Section 201 authorizes the Federal Insurance Commission to issue a charter to any stocks, mutual, or reciprocal insurer, reinsurer, or surety, the U.S. Branch of Alien Insurer or Surety, or any other alien insurer or surety maintaining in the United States at all times trust funds of not less than \$50 million, or such lesser amount as may be approved by the Commission.

Upon the issuance of a Federal charter, the State charter or similar authority of an insurer which is converting to a Federal charter will be preempted and terminated, except that any such insurer shall be deemed to continue its corporate or other existence for all purposes of Federal and State law.

A federally-chartered insurer shall be deemed to be authorized to do business in any State, except that the appropriate regulatory authority of any State may, for cause and upon a showing to the satisfaction of the Federal Insurance Commission that such action is necessary or justified, revoke the authority of the federally-chartered insurer to do business in that State.

The insurance obligations of all fed- * * * federally-chartered insurer may elect to * * * anteed in accordance with the provisions of title I.

Section 201 further provides that a federally-chartered insurer may elect to surrender its Federal charter and return to a State-chartered status.

Except as otherwise specifically provided, a federally-chartered insurer shall have the powers of a business corporation chartered in the District of Columbia under the District of Columbia Business Corporation Act.

Section 202 sets forth the procedure for organization of a federally-chartered insurer. It states that in the case of a group or fleet of insurers under common management or subject to the effective control of one person, no one or more of the insurers which are part of such group or fleet shall be federally chartered unless all are federally chartered.

Section 203 sets forth the conditions under which a federally-chartered insurer may commence doing business.

Section 204 provides that a federally-chartered insurer shall be exempt from the provisions of any State law.

First, which requires the establishment and maintenance of reserves;

Second, which requires participation in a State insolvency guaranty plan;

Third, which provides for the regulation of investments; and

Fourth, which provides for the regulation or fixing of rates or premiums, or of classes of risks, except in the case of an assigned risk plan or other residual market mechanism or in the case of any line of insurance in which the Federal Insurance Commission determines that the insurer competes principally for the producer's business rather than the business of the ultimate consumer.

Section 204 makes clear that States may continue to levy taxes on federally-chartered insurers transacting business within their jurisdictions but provides that federally-chartered insurers would exceed the amount of tax which would be imposed on the least taxed insurer doing the same type of business and organized under the laws of any State other than the taxing State.

Section 204 also provides, for the purpose of any tax law enacted under the authority of a State, that a federally-chartered insurer shall not be treated as an insurer organized or incorporated under the law of the enacting State. Thus, a federally-chartered insurer would be exempt from State retaliatory taxes. However, for the purposes of any other law enacted under the authority of a State or the United States, a federally-chartered insurer would be treated as an insurer organized or incorporated under the laws of the State in which its principal place of business is located.

Section 205 sets forth the investment criteria for federally-chartered insurers. The objective of this section is to require that a federally-chartered insurer invest funds in an amount equal to the sum of its policyholder obligations and minimum capital and surplus, or guaranty fund required by law, in assets of integrity and stability. With respect to amounts above its policyholder obligations and minimum capital and surplus, or guaranty fund required by law, the insurer is free to invest such funds at its own discretion without regard to the investment criteria set forth in the bill.

Senator BROOKE. Mr. Chairman, I want to take this opportunity to thank you for calling these hearings. I think they are important hearings not only to our Banking Committee but I think its very, very important to policyholders and to the insurance industry as well, and I look forward to what I know will be excellent testimony from those witnesses that have been invited.

The CHAIRMAN. Thank you very much, Senator Brooke.

Chairman Williams, go right ahead, sir. If you would like to abbreviate your statement in any way we will be happy to have it printed in full in the record and proceed to questioning at any time you wish.

STATEMENT OF HAROLD M. WILLIAMS, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. WILLIAMS. Mr. Chairman and members of the committee, I appreciate the opportunity to appear here today before this committee to participate in your consideration of S. 1710 and, more generally, in your consideration of the nature and structure of the insurance industry. The bill obviously raises important questions concerning the regulation of insurance companies which are among the principal financial institutions of our economy. As you undoubtedly know, the SEC's jurisdiction with respect to insurance companies is rather limited and, as a result, it is impossible for us to draw any broad conclusions based on experience. I would, however, like to share and convey to you some of our general observations and some of my personal views on this subject.

SEC LIMITED REGULATION OF INSURANCE COMPANIES

The SEC does not possess general regulatory authority over the business operations of insurance companies, nor does it regulate the relationship between policyholder and insurance company. We do, however, exercise jurisdiction with respect to some aspects of the relationship between an insurance company and its public stockholders, and with respect to transactions in securities issued or owned by insurance companies.

Pursuant to the Securities Act of 1933, an insurance company or insurance holding company which makes a public offering of securities must file a registration statement with the Commission. In addition, while section 3(a)(8) of the Securities Act exempts most insurance policies or annuity contracts, variable annuities and variable life insurance contracts are subject to all the requirements of the Securities Act. Unlike traditional insurance products, the benefits under variable annuity and variable life contracts are dependent upon the result of a specific portfolio of securities and are not guaranteed by the insurance company.

In conjunction with our consideration in the early 1970's of the status of variable life insurance under the Federal securities laws, the Commission had occasion to consider the adequacy of State insurance regulation with respect to the disclosure provided to purchasers of insurance contracts. The Commission determined that, where the contract is in variable terms, the disclosures provided by the Securities Act were necessary, since State insurance regulation is directed primarily at maintaining the solvency of insurance companies rather than at providing the purchaser with full disclosure. Having made that decision, the Commission and its staff now review disclosure documents filed with respect to both variable annuity and variable life contracts and have developed a certain experience therewith.

Other disclosures required by the Federal securities laws are quite circumscribed in the case of insurance companies. Many insurance companies are exempt from the registration and annual and periodic reporting requirements of the Securities Exchange Act of 1934 by section 12(g)(2)(G). A company qualifies for this exemption if its domiciliary State regulates proxies and insider trading in a manner comparable to the regulation contained in sections 14 and 16 of the Exchange Act, and if it files annual "convention" (financial) statements on a form prescribed by the National Association of Insurance Commissioners ("NAIC"). The NAIC convention statement requires neither an audit by independent accountants nor periodic reporting as is mandatory for other corporate issuers. Holding companies with insurance subsidiaries are not eligible for this exemption, however, and are subject to the registration and reporting requirements of the Exchange Act to the same extent as other corporations.

There are other requirements of the Exchange Act which do apply with full force to insurance companies. For example, section 13(d) provides that a person who acquires more than 5 percent ownership of an equity security of an insurance company must file a report with the Commission, as must an insurance company acquiring more than

5 percent of an equity security of another corporation. In addition, the antifraud provision of the Exchange Act, section 10(b) and rule 10b-5, as well as other antifraud provisions of the Federal securities laws, are of importance with respect to insurance companies since the business of insurance involves day-to-day trading in securities. In addition, of course, trading exists in securities issued by publicly held insurance companies.

Insurance companies, or more commonly their affiliates, are subject to registration as broker-dealers under the Exchange Act, when they act in that capacity. Most insurance company subsidiaries registered as broker-dealers are primarily in the business of selling variable annuity and variable life contracts and mutual funds.

The Investment Company Act of 1940, which regulates pooled investment media, specifically excludes insurers from its coverage. Certain "separate accounts" of life insurance companies used to fund variable annuity and variable life contracts are, however, registered under the Investment Company Act and are thus subject to its comprehensive regulation. In addition, since the 1960's, insurance companies have increasingly sponsored their own muture funds by acquisition or formation. By 1974 insurance companies—predominantly through subsidiaries—managed over 50 percent of all mutual fund assets. Insurance companies are not bound by Federal statutes, such as the Glass-Steagall Act or the Bank Holding Company Act, which would regulate these and other noninsurance activities.

Finally, an insurance company or, more frequently, its affiliate, is subject to registration under the Investment Advisers Act of 1940 when it acts as an investment adviser, except when its only clients are insurance companies.

ENFORCEMENT ACTIONS

While, as the above discussion indicates, our jurisdiction over insurance companies is rather limited, we have recently brought several enforcement cases relating to insurance companies, which might be of interest to the committee, and we have several cases pending. These actions have included administrative proceedings, actions for injunctive and ancillary relief, and referrals and assistance rendered in criminal prosecutions conducted by the Justice Department. Today, I would like to talk about the five cases we have instituted in the past year. Of the five cases, four were actions in the district courts and the remaining case was an administrative proceeding under the Exchange Act. Final relief was obtained in each of these cases as a result of consents submitted by the defendants.

Two cases were interrelated and involved allegations of self-dealing. These are the American Commonwealth Financial Corporation case and the National Pacific Corporation case.

In May 1977, the Commission brought an action against American Commonwealth Financial Corp., a Texas-based publicly held insurance holding company, and nine other defendants, in the U.S. District Court for the Northern District of Texas. The Commission alleged that the defendants had engaged in a fraudulent course of conduct whereby they used the assets of American Commonwealth and other publicly held companies for their personal gain. These activities are

alleged to have begun in about February 1975 upon the assumption of control of American Commonwealth by a new management group.

The allegations of self-dealing in the complaint related to, among other things, the use of the assets and credit of public companies for loans, and guarantees of loans, made directly and indirectly to certain of the defendants. In connection with personal bank loans, restrictions were imposed on American Commonwealth's ability to conduct certain businesses, issue stock, increase capital, or grant dividends. Also, personal loans were secured from the publicly held controlled companies though the pledge of assets of doubtful value. Sales and exchanges of such assets and securities and notes of similarly questionable value were made. Finally, there were alleged to be a variety of omitted, false, and deceptive disclosures.

In June 1976, American Commonwealth transferred control of one of its subsidiaries, National American Life Insurance Co., to National Pacific Corp., a private company owned principally by several west coast promoters. According to the Commission's complaint, filed in September 1976, the National Pacific group immediately set out to engage in a series of self-dealing transactions which resulted in the misappropriation of several million dollars. The principal method by which the National Pacific group operated was to obtain lucrative union group insurance contracts for National American from union health and welfare funds, using other companies to obtain these contracts. Once the insurance contracts were obtained by National American through reinsurance agreements with the other companies, the proceeds of the contracts were diverted to the personal use of the National Pacific group. In addition, cash was obtained through the transferring of notes of highly questionable value to National American in exchange for cash. One month before the Commission's complaint was filed, the control person of National American, without any board of directors authorization, and contrary to applicable State law, transferred \$1.1 million in National American funds to a Swiss bank account which had just been opened by a newly formed Swiss company. Following the filing of the Commission's complaint, the Federal court, upon the Commission's motion, appointed an equity receiver over National American and the court ordered, pursuant to a consent decree, that the \$1.1 million be returned to National American. About \$835,000 has been returned, and the control person of National Pacific has been held in contempt of court for failure to return the remainder.

An interesting aspect of the National Pacific case is that, just prior to National Pacific's acquisition of National American, a Louisiana insurance company, the State of New Jersey had turned down National Pacific's application to acquire a New Jersey-based insurer, on grounds of unsuitability of the applicant. In Louisiana, however, State approval of such an application is not required, so National Pacific acquired a Louisiana corporation, using, as the source of funds for the acquisition, the proceeds of a dividend from an Arizona insurance company that the State of Arizona had declared illegal, but which National Pacific failed to return to that company.

Two other cases involved failures to prepare adequate financial statements, principally relating to loss reserves. The first culminated

in administrative proceedings under section 15(c)(4) of the Exchange Act against Government Employees Insurance Co., commonly referred to as "GEICO". In these proceedings, the Commission found that GEICO, after April 1975, failed to make necessary disclosures of changes in its manner of computing loss reserves, causing liabilities to be understated. In addition, the Commission found that GEICO capitalized the carrying value of acquisition costs on its balance sheet which raised questions. The changes discussed above had the effect of substantially decreasing the net loss which GEICO reported in various filings with the Commission and in reports made to its shareholders and the press.

The changes made by GEICO in the manner of computing its loss reserves were inconsistent with that firm's prior practice and were not supported by available data or by the findings of GEICO's outside auditors and certain consultants. Also, GEICO's method of valuing acquisition costs raised questions. GEICO historically deferred certain costs incurred in acquiring insurance businesses, thus avoiding the negative impact such costs would otherwise have had on current earnings. Recoverability of these costs through future underwriting profits is, however, a necessary prerequisite to deferral, and, of course, the asset must be reduced as portions are deemed non-recoverable. We found that GEICO failed to make downward adjustments in the valuation of its acquisition costs. We also found in this case that an officer of GEICO sold GEICO securities while in possession of material non-public information concerning these matters.

Our fourth and most recent enforcement action against an insurance company, *SEC v. Fisco*, an action for injunctive and ancillary relief, was filed and consented to on August 18 of this year. While the Commission's complaint alleged other areas of fraud, the principal fraud alleged in *Fisco* was the understatement of reserves for losses. As a result of the understatement, over a 3-year period, Fisco, a casualty insurance company, was able to report increasing earnings, when in fact, we alleged, it was incurring substantial losses.

According to the complaint, numerous methods were used by Fisco to understate its loss reserves, including:

1. Direct orders from management to "freeze" reserve increases even where a Fisco claims adjuster had indicated that the previously set reserve was substantially understated.

2. The adoption of a computer program designed to "freeze" reserve increases. The program operated in such a way as to negate all attempts to increase reserves for particular classes of claims.

3. The use of so-called GI parties. These were reviews, by claims personnel, of all claims files. The sole purpose was to find reserves which could be reduced or deleted in their entirety.

4. The so-called Black Friday incident. In February 1972 a physical inventory of the claims files in Fisco's Philadelphia office was taken, involving a comparison of a computer printout of existing files with the files themselves. Claims files reflecting approximately \$1,000,000 in reserves were not located and management ordered that the reserves for those claims be deleted as of December 31, 1972. A few weeks later it was found that the missing files were in transit to Fisco's New

Jersey office; notwithstanding discovery of the missing files Fisco failed to reverse the entry deleting the reserves for these claims.

After having reported doubled earnings for the record 1970 through June 1973, Fisco reported in early 1974 an operating loss of approximately \$39,000,000 which completely eliminated all prior reported earnings of the company. This revision principally resulted from its policy of understanding loss reserves.

The last case which I will discuss this morning, involving Vanguard Security Funding Corp., a holding company, also relates to misleading financial statements. It is of particular note that the direct object of the alleged fraud there was a State regulatory agency, rather than the trading market in securities. The Commission alleged that in 1974 Vanguard's operating subsidiary, which is engaged in underwriting individual and group life and health insurance and group disability insurance risks, entered into sham transactions in which it acquired real estate in exchange for surplus notes. The alleged purpose of these transactions was to increase Vanguard's statutory surplus, removing an impairment of capital for State regulatory purposes. In a financial statement filed by Vanguard with the Commission, Vanguard valued the newly acquired real estate at the stated value of the surplus notes. The surplus notes, a form of debt apparently unique to the insurance industry, provided for payment only if and when the statutory surplus of Vanguard exceeded a certain predetermined amount. It was alleged that the value of real estate and debt were substantially overstated and that the reported net loss and retained earnings deficit were substantially understated in those financial statements. The Commission also alleged that Vanguard failed to disclose that it filed false and misleading statutory surplus reports with the Alabama State insurance department, including false and misleading appraisals of certain of the real estate. The operating subsidiary of Vanguard was placed in receivership by the State insurance department.

The limited number of these cases makes it difficult to generalize about abuses since the cases themselves reveal a variety of misconduct. A few observations may, however, be made regarding these cases, which, with few exceptions, involve smaller insurance companies. Insurance companies represent large pools of liquid assets, which lend themselves to a variety of intricate techniques designed to enrich controlling persons through looting or use of assets to gain control of other companies or otherwise to mislead regulatory authorities or defraud the public. The American Financial and National Pacific cases indicate the rather amazing speed at which determined persons appear to be able to utilize the assets of insurance companies for their personal gain. In addition, more than one of our enforcement cases has involved fraudulent usage of reinsurance agreements either to conceal under-reserved deficiencies or to transfer overvalued assets from company to company.

Other areas of abuse which have surfaced in our investigations are inadequate loan loss reserves and irregularities with respect to valuation of assets. These latter abuses appear to grow out of the desire of insurance companies to inflate earnings and to protect or increase surplus which determines the amount of insurance they can write.

GENERAL OBSERVATIONS

The above description of our enforcement activities with respect to insurance companies also indicates both the growing complexity of possible misconduct in this area, and the difficulties faced by State regulators, with their limited jurisdiction and resources, in attempting to deal with the varieties of problems presented by multistate insurance companies. S. 1710 recognizes that there is at least some question as to the adequacy of State regulation and proposes to supplement it by a voluntary Federal Insurance Guaranty Fund and voluntary Federal chartering of insurance companies. I recognize that, in its present form, the bill does not directly affect the nature of our jurisdiction in this area. However, drawing from our enforcement actions and our experience with regulatory matters dealing with other financial institutions, as well as from my own personal observations, I would like to make some comments about S. 1710 and raise some questions which I think the committee may wish to consider.

First, both titles of the proposed bill provide for voluntary participation by insurance companies. While the freedom from State rate regulation has been articulated as an attraction of Federal chartering, I wonder whether this is enough of an incentive to attract participation. I am also concerned with respect to whether the types of insurance companies we have brought enforcement actions against would voluntarily come into a Federal system of regulation. In addition, the voluntary nature of the Federal Insurance Guaranty Fund may provide problems of adverse selection against the Federal fund or State funds, as some 46 States have enacted legislation establishing guaranty funds to protect policyholders against loss in the event of the insolvency of their property and liability insurers.

My next observation relates to an aspect of the regulatory structure reflected in the proposed bill. The proposed legislation does not appear to provide authority explicitly—except perhaps for federally chartered insurance companies—for direct regulation of insider misconduct. Some States appear to have such statutes, and there are similar Federal statutes dealing with other financial intermediaries.

Finally, I would like to make some general observations concerning legislation of the nature presently before this committee. In dealing with major regulatory proposals regarding any financial intermediary, and in particular a proposal to establish another specialized Federal agency, one must consider the growing diversity of financial services such companies are beginning to offer. No longer are banks, brokers, or insurance companies content to remain within traditionally defined areas as to which their differing regulatory structures have been established. Accordingly, any comprehensive legislation should seek both to create effective regulatory mechanisms which recognize this diversity and to avoid overlapping jurisdiction.

I hope that my testimony here today, while rather limited, will be of assistance. I would be happy to respond to any questions the members of the committee might have.

The CHAIRMAN. Well, Chairman Williams, I want to thank you for a masterful summary of your testimony. I thought it was going to take about half an hour and you took about 10 minutes. You did a beautiful job.

Mr. Chairman, in your statement you note and you stress repeatedly that the SEC's jurisdiction over insurance companies and over dealing with some of the insurance company misconduct you describe is limited. The bill that we have before us, as you say, would set up an extensive Federal regulatory mechanism for insurance companies.

Do you think we could achieve the same or some of the same results without a new bureaucracy by giving the SEC more extensive authority to oversee and regulate the financial practices of insurance companies?

Mr. WILLIAMS. I would like to give you a more considered statement, but let me share some thoughts with you.

The focus of the Commission in relation to insurance companies or to, for example, other financial intermediaries other than the types we regulate directly is much more concentrated on protection of investors than it is on protection of policyholders. It's a different focus.

Now I suspect that it would be difficult to protect investors without protecting policyholders in the process, but it is a different focus. We are not concerned only with solvency. We are concerned with the adequacy of disclosure which will enable a potential investor, for example, in an insurance company, to know what he is investing in and also to assure that insider activities within insurance companies are not inconsistent with the securities laws.

To some extent at least, I think broader authority would serve the same purposes; but I am reluctant to volunteer an opinion this morning without having thought through its implications more deeply.

The CHAIRMAN. Well, as Senator Brooke stresses so well in his statement, there is a close analogy, or there may be some analogy at least, to bank regulation. The SEC has jurisdiction over the issuance of securities by bank holding companies, for example, and banks to their stockholders but the regulation of the banks with respect to depositors is not the SEC's fundamental jurisdiction but that of the regulatory agencies.

Mr. WILLIAMS. That's right. The parallel would then call for equivalent jurisdiction to the FDIC or the Comptroller.

The CHAIRMAN. After all, we have a very complex and sophisticated and rather successful insurance—very successful insurance industry, and it's progressed very well for many, many years without having Federal bureaucracy operate in this way, and I just wonder if we have much of a case for providing such a new bureaucracy. Perhaps we do.

Mr. WILLIAMS. I share your reluctance in several senses. One, I think before an additional Federal bureaucracy is created the burden of proof does indeed exist to show the urgent need for it.

Second, as I indicate in my testimony, there's an enormous amount of potential and actual overlap in the banking area between the Commission and the other parties involved, and I hope we can learn from that rather rapidly if indeed there is a place for Federal intervention with respect to insurance.

Third, the problems, to the extent that they exist in the insurance industry, perhaps ought to be dealt with—and this is strictly a personal observation—in a more precise way. For example, the companies that we have been looking at in connection with the insider activity

type of situations are essentially the small companies. Now maybe that's a factor of size. I can't generalize from this small number of cases. It might be a factor of the particular State jurisdiction involved. Some States are certainly more aggressive and more responsible than others in terms of how they pursue their regulatory responsibilities.

The CHAIRMAN. Well, that brings me to the next problem. I don't want to interrupt except to point out that the difficulty here is that if you make this completely voluntary, wouldn't there be a tendency for at least some insurance companies to opt out from under the vigorous strict State enforcement to a Federal chartering, whereas the permissive States where perhaps you do need some strengthening would continue to hold onto their jurisdiction because the insurance companies would favor to some extent perhaps that permissive atmosphere? So it would tend to weaken regulation in that sense.

Mr. WILLIAMS. It may be more complex than that. An insurance company doing business in 50 States, one of the larger ones, for example, involved in all the regulatory problems of rate setting—for example, automobile insurance rates and workmen's compensation—I think would be very inclined to move toward Federal regulation. It depends on what you're shopping for.

My concern, as I expressed in my testimony, is that probably the very kind of companies that by and large, we have become concerned about would not opt to include themselves within the legislation. Perhaps over time so many would include themselves that one which did not would be conspicuous by its absence, and yet I think there are probably still people walking the streets who walk into a State bank and assume that all banks are the same.

The CHAIRMAN. We have a problem of competition in laxity with the three Federal banking regulatory agencies as you may know. At least that's been the accusation by Chairman Burns of the Federal Reserve Board. You express some doubts as to whether S. 1710 offers sufficient incentives to attract voluntary participation by insurance companies and particularly companies such as those against which you have brought enforcement actions.

The HUD witness who will testify later, Mr. Hunter, says that Federal preemption of State regulation may be necessary to give protection to policyholders of insurance companies threatened by insolvency, the weakest companies as well as the strongest.

What is your view of Federal preemption?

Mr. WILLIAMS. Federal preemption specifically in relation to total regulation of insurance companies?

The CHAIRMAN. Yes, sir.

Mr. WILLIAMS. I'm not prepared to give a complete answer on that.

The CHAIRMAN. Finally, could you provide the committee with some recommendations for changing the securities laws to prevent abusive practices in the insurance industry? You said you weren't prepared to give a complete answer.

Mr. WILLIAMS. Not this morning.

The CHAIRMAN. When you correct your remarks for the record perhaps in writing?

Mr. WILLIAMS. I'd be delighted.

The CHAIRMAN. That will be fine.

Senator Brooke.

Senator BROOKE. Thank you, Mr. Chairman.

Chairman WILLIAMS, I first want to thank you for your very thorough review of the jurisdiction of the SEC over the insurance industry and recent enforcement actions undertaken by the SEC with respect to the insurance company violations of our securities laws. I do have a number of questions, sir. I will try to ask them briefly and there will be some I will ask you to submit for the record in writing.

First, I recognize that the SEC's regulatory authority over insurance companies is limited as you point out and yet you have initiated a number of enforcement cases against insurance companies. Now how many persons does the SEC have assigned to investigate and enforcement of insurance company violations of the securities laws?

Mr. WILLIAMS. I will have to get you that number. It's a small group obviously, and I would say probably on the order of a half dozen people.

Senator BROOKE. Would you submit the actual number?

Mr. WILLIAMS. Yes.

Senator BROOKE. But you think it's in the neighborhood of six; is that correct?

Mr. WILLIAMS. That's right.

Senator BROOKE. Now does your fiscal 1978 budget call for an increased enforcement effort with respect to insurance company violations of the securities laws?

Mr. WILLIAMS. Our fiscal 1978 budget?

Senator BROOKE. Yes.

Mr. WILLIAMS. I would remind the committee that we don't have an authorization from this committee but—assuming we were to get one—I believe that the authorization would provide that opportunity. The appropriation is flat with last year.

Senator BROOKE. Is what?

Mr. WILLIAMS. The appropriation is even with last year in dollars except for some cost differentials on the same level of activity, but the plan within the Commission in terms of our own internal allocation of resources would call for some additional resources in the insurance area. Yes.

Senator BROOKE. Now does this planned increase in your enforcement effort reflect a concern on the part of the Commission that abuses of the kind you have described in your statement this morning may be more widespread than indicated by the limited number of enforcement actions initiated so far?

Mr. WILLIAMS. Yes, it does. I might note we have issued two formal orders of investigation, and we have something on the order of a half dozen under investigation.

Senator BROOKE. Does the SEC bring enforcement action against an insurance company if it feels that alleged abuses are being adequately addressed by State regulatory authorities?

Mr. WILLIAMS. We try to work and do work with the State regulatory authorities to some extent and I think, as I indicated in my testimony, there are several instances where at least a piece of the ongoing proceedings is being conducted by one or another of the State insurance commissions involved. To some extent we do proceed even where there is a State agency involved where we believe that the pro-

phylactic effect, if you will, or the kind of visibility that comes from an SEC proceeding, might have a deterrent effect on other similar situations.

Senator BROOKE. Now in the five cases that you mentioned in your statement, to your knowledge, were State insurance regulations aware of the alleged abuses before the SEC investigation was initiated?

Mr. WILLIAMS. I can't generalize. I'm quite sure if I recall correctly, in one of the cases the answer would be yes. In others, I don't know whether our records would show that.

Senator BROOKE. Would you supply that for the record as well?

Mr. WILLIAMS. Yes (see letter at p. 40).

Senator BROOKE. Now, Chairman Williams, aside from your responsibilities at the SEC, you are a very knowledgeable observer of the insurance industry and insurance regulation and in your statement you mentioned the limited jurisdiction and resources of State regulators in attempting to deal with the variety of problems presented by multi-State insurance companies.

Would you care to expand on that?

Mr. WILLIAMS. Well, at the risk of generalization, the quality of State regulation of insurance companies is essentially very uneven. Some States seem to do overall what appears to be a good, strong job of regulation. You will note in one of the actions that we brought one State refused to permit the defendant in one of our actions to acquire an insurance company in that State's jurisdiction. Yet, that same defendant was able to go into other States and play its game. So there is an unevenness. It relates primarily, I think, to the resources and the professionalism of the people involved. Certainly there are jurisdictions where the insurance commissioner is also the commissioner and perhaps the secretary of state and a number of other things; the staff is virtually nonexistent; and, in effect, regulation is probably more a revenue-producing measure than it is regulation. But that's a general statement. I couldn't describe the extent of true regulation today on a State-by-State basis, but I think that there are many States where that situation exists.

Senator BROOKE. Would it be fair to say that the quality of regulation for solvency purposes is also very uneven across the country?

Mr. WILLIAMS. Oh, yes.

Senator BROOKE. Is it not true that only a small portion of the premium taxes derived from insurance companies is used to finance State insurance departments?

Mr. WILLIAMS. I believe that's right, yes.

Senator BROOKE. Is it not true that the budgets allocated to insurance departments in some States—and you referred to it—are grossly inadequate to permit proper regulation for solvency purposes?

Mr. WILLIAMS. I would be guessing on that one, but I would suspect you're right. Although, looking at it in a different way, in terms of the percentage of insurance company activity, it may be that the States we are talking about are really involved in it as a domiciliary State. I would guess that perhaps 10 percent of the insurance company activity is in States whose insurance departments have inadequate budgets, and I'm a little concerned about that. One of my questions would be whether we need the kind of blanket regulation we're talking about,

even though voluntary, in order to get at the kinds of abuses which are more frequently found in small companies and that I think tend to be geographically concentrated.

Senator BROOKE. Now I take it from your testimony that you might some day ask the Congress to revise or repeal section 12(g)(2)(G) of the Securities and Exchange Act of 1934 which exempts a company from annual and periodic reporting requirements if its domiciliary State regulates proxies and insider trading and if it files annual convention statements in a form prescribed by the National Association of Insurance Commissioners.

Would that be fair to surmise that from what you have said?

Mr. WILLIAMS. We are not at the point of asking for that. It's something that I think we will consider in the context of future legislation. But as a personal observation, I must say that I have some concern about the extent to which insurance companies are not audited by independent accountants. I think it aggravates the problem. Although, in fairness, most of the major insurance company problems of recent years have been with audited companies, so auditing is not necessarily the be-all and end-all solution. And if you look at the problems that have occurred, apart from the kind that we have talked about in some of these smaller cases, there are problems that I'm not sure would be dealt with any better by Federal regulation. For example, the question of the adequacy of insurance company reserves was certainly a key in the GEICO case. And I think that the way in which insurance company reserves are required has some other characteristic problems which can be dealt with by the accounting profession as well as they can by Federal regulation.

Senator BROOKE. Are you aware of the NAIC convention statement?

Mr. WILLIAMS. Yes.

Senator BROOKE. Do you feel that offers adequate protection to the public?

Mr. WILLIAMS. Well, in principle, what the act is saying is that it does. It substitutes for an annual report. I'm not fully sure that's the case now.

Senator BROOKE. I'm sorry. I didn't hear you.

Mr. WILLIAMS. In many ways it's hard to understand, and I don't think it really communicates very well to investors or to policyholders.

Senator BROOKE. Now you have stated that under Senate 1710 the wide problems of adverse selection against the Federal fund or State funds. Now the Federal insurance guarantee fund is modeled on the FDIC which, as you know, provides for voluntary membership. In my own Commonwealth of Massachusetts, while many banks have joined the FDIC, a large number of institutions are not members of the FDIC, but instead belong to the Massachusetts Central Fund, a depositor insurance mechanism which existed really prior to the establishment of the FDIC.

Now I know of no problems of adverse selections—none at least have come to my attention in this area. Of course, adverse selection could be prevented by Federal preemption of solvency regulation, but I would personally be very reluctant to take such a step. Is it not

possible that the establishment of a well-run Federal guarantee alternate would cause State regulators to improve the quality of their regulation, thus minimizing the possibility of adverse selections?

Mr. WILLIAMS. It's possible. I'm trying to think through in my own mind why they would be motivated to do so when in a sense their responsibility would be lessened rather than enhanced. If you start from the premise that they are not doing the job now, why would they be more sensitive when there is a guarantee alternative that would—at least might—deprive them of some revenues but would also deprive them of any blame if there was a likelihood of another problem arising? I don't know how to answer. I could see it theoretically, but I don't expect it would happen.

Senator BROOKE. You don't expect it would happen?

Mr. WILLIAMS. No.

Senator BROOKE. I have one final question. My time is up. I may want to submit further questions to you, as I said, and even this one, in writing. You mentioned your concern that title I of S. 1710 may not provide for adequate regulation of insider misconduct. Now I would have thought that section 108 of the bill provided protection in this regard. I don't know whether you have looked at that, but I would appreciate it if your staff would supply such revisions as you might suggest to provide protection against insider misconduct, if you feel that section 108 does not adequately address, if you have some suggestions or your staff, I would be most grateful.

Mr. WILLIAMS. I would be delighted.

Senator BROOKE. Thank you, Mr. Chairman.

[The following letter was received for the record:]

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., November 18, 1977.

HON. WILLIAM PROXMIRE,

Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate,
Washington, D.C.

DEAR SENATOR PROXMIRE: This is in response to the questions raised by you and Senator Brooke during my testimony before the Committee on Banking, Housing and Urban Affairs on September 12, 1977, concerning S. 1710, the proposed Federal Insurance Act of 1977.

1. Senator Brooke asked how many persons the Commission has assigned to investigate and monitor insurance company violations of the securities laws (Transcript of Testimony at p. 17).

As I indicated at the hearing, at this time we have only a small group of people engaged in the investigation and monitoring of insurance company compliance with the securities laws. Our staff has advised me that approximately twelve persons have significant assignments related to investigations of insurance companies. However, due to the Commission's heavy workload, those persons can devote only a portion of their time to such activities. Thus, the Commission currently has the equivalent of six persons working full time on investigating and monitoring insurance company compliance with the securities laws.

2. Senator Brooke asked whether, in the five cases which I noted in my prepared statement, the state insurance regulators were aware of the alleged abuses prior to the initiation of the Commission's investigation (Transcript of Testimony at p. 19).

We believe that state insurance regulators in the domiciliary states of the five insurance companies in question (GEICO, District of Columbia; National Pacific, Louisiana, and Arizona; Vanguard, Alabama; ACFC, Texas and Louisiana; and FISCO, Pennsylvania) were, in general, aware, prior to the commencement of the Commission's investigation, of at least some, if not all, of the activities of these companies giving rise to the Commission's investigations and

enforcement proceedings. In some cases, some of the information giving rise to the Commission's investigations actually derived from state regulatory authorities.

3. You asked whether changes could be made in the securities laws to achieve some of the same goals sought in S. 1710; and whether the formation of a new bureaucracy designed to oversee the insurance industry could be avoided by granting the Commission more extensive authority in that area (Transcript of Testimony at pp. 12, 16).

The Commission has not yet had sufficient experience with the issues involved in your inquiry to be able to make definitive recommendations for amendments to the present exemptions for insurance companies under Section 12 of the Securities Exchange Act of 1934. Such definitive recommendations should follow both greater experience and a specific study of the problems involved. Nevertheless, if the Committee is interested in pursuing amendments to existing laws and to S. 1710, the Committee may wish to consider the following alternatives:

A. Audited financial statements

As you know, Section 12(g)(2)(G) of the Securities Exchange Act provides an exemption from the registration requirements of Section 12(g) for any security issued by an insurance company, provided (1) such insurance company files annual "convention" statements as prescribed by the National Association of Insurance Commissioners ("NAIC"); (2) such insurance company's domiciliary state regulates proxy solicitations in conformance with NAIC provisions; and (3) such insurance company's domiciliary state regulates insider trading in the manner provided by Section 16 of the Exchange Act. The apparent rationale behind the creation of the exemption was that the reports filed with state authorities, and the regulation of proxies and insider trading by the states, would provide an adequate substitute for the provisions of the Exchange Act which would otherwise be applicable.

A minor revision which would constitute a minimal intrusion by the federal government in the insurance field might be simply to require that annual financial statements of insurance companies be audited. This change would impose what is essentially a sound and common business practice on those insurance companies which presently are not subject to such requirements.

The Committee might also wish to consider providing a means for all state insurance regulatory authorities and the public to obtain access to such financial information, if it were required. For example, the establishment of a central repository for this information could promote more efficient application of the states' laws as well as existing federal law.

B. Requiring state authorities to adopt disclosure and proxy solicitation rules substantially equivalent to those imposed by this Commission.

The present coverage of insurance company activities by the Securities Exchange Act is somewhat irregular. Section 12(g)(2)(G) of the Securities Exchange Act, in essence, exempts insurance companies from filing registration statements, annual statements and proxy solicitation materials in the form typically required by the Commission. Among the further consequences which attend this exemption is the immunity of insurance companies from the provisions of Section 13(e) of the Securities Exchange Act. Section 13(e) gives the Commission authority to adopt rules relating to the purchase of equity securities by or on behalf of the issuer of such securities or a control person of such issuer as defined in the section.

At the same time, and somewhat paradoxically, tender offers relating to the securities of insurance companies are fully subject to Commission regulation under Section 14(d) of the Securities Exchange Act.¹ The reporting requirements of Section 13(d), regarding beneficial ownership, are also applicable to insurance companies.² This puts the Commission in the difficult position of having responsibility for policing tender offers, while related disclosure problems may go undetected because of the statutory exemption from other requirements of the securities laws.

¹ The reason for this anomaly is probably that insurance companies do not object to regulation of tender offers for their securities made by others.

² Also, under Section 12(g)(2)(G)(iii), insider trading of the securities of insurance companies is subject to the substantial equivalent of Commission regulation under Section 16 of the Exchange Act.

One solution would be to amend Sections 12(g)(2)(G) (i) and (ii) to provide for the filing of annual reports by insurance companies with their domiciliary state commissioners of insurance in a form which is the substantial equivalent of the annual reports required by the Commission for reporting under Section 13 of the Securities Exchange Act, and to provide for domiciliary state regulation of proxies which would be the substantial equivalent of the Commission's regulation of proxies. This change would be consistent with the essential purposes of the securities laws.

C. Repeal of Section 12(g)(2)(G)

A third possibility would be to repeal Section 12(g)(2)(G). This would impose a uniform system of financial reporting on all publicly-held insurance companies, and would enable the Commission to provide a uniform enforcement policy for disclosure by such companies. Since insurance subsidiaries of publicly-held companies are already subject, in effect, to Section 13 reporting, the repeal of Section 12(g)(2)(G) would be equalizing in effect and purpose. However, such a change would not address all the issues which S. 1710 attempts to address. Moreover, it would not have an effect on the mutual companies, which are a major force in the insurance industry.

4. Finally, Senator Brooke asked for suggestions for amendments to enhance the protections against insider misconduct provided by S. 1710 (Transcript of Testimony at p. 24).

As you know, Section 106 of S. 1710 provides procedures for enforcement actions against an insurance company or its director, officer, employee or agent where such company or person has violated or appears about to violate the provisions of the Act or a regulation under the Act. There are also provisions for enforcement actions against an officer or director of a federally guaranteed insurer who violates any law or regulation, engages in any "unsafe or unsound practice", or breaches his duty as a director or officer, if the violation or breach of duty causes, or may cause, financial loss and involves personal dishonesty or gross negligence. However, this section contains no grant of authority to promulgate regulations regarding the conduct of officers, directors or employees of insurance companies covered by the Bill. Section 106 contemplates only ad hoc remedial activity.

The Insurance Commission established by the Bill is authorized, in Section 107, to "prescribe such rules and regulations as may be necessary to carry out its responsibilities under the provisions of this Act" with respect to federally guaranteed insurers. Since Section 107 specifies the areas to be dealt with by regulation, it is unclear whether the Insurance Commission could promulgate rules regulating misconduct of officers, directors, employees and agents of federally chartered insurers. In this context, the requirements, mentioned above, that insurance company financial statements be audited and made publicly available in a central repository, may expose some types of self-dealing to public view and have a salutary prophylactic effect.

Another possible solution would be to add a paragraph to Section 107(a) granting the proposed Federal Insurance Commission power to prescribe rules designed to protect against insider misconduct. Some states appear to have regulatory provisions along these lines, such as those which limit or preclude loans to insiders. Federal statutes dealing with financial intermediaries, such as the Investment Company Act of 1940, prohibit certain types of self-dealing by affiliates unless the transactions are found to be fair and permitted by Commission rule or order. (See Sections 17(a), 17(b) and 17(d) of that Act.) The proposed Insurance Commission could be granted such authority, either by rule-making or adjudicating or both, over transactions between insurance companies and their affiliates.

An alternative means of approaching the desired goal, involving a lesser amount of direct governmental regulation, would be to add to S. 1710 a specific provision to prohibit sales or purchases of property to or from an affiliate of an insurance company, or the rendering of services by such affiliate, unless the affiliate were regularly engaged in the business of purchasing or selling the property or services and the consideration received or paid were substantially equivalent to prices or rates charged or received in arms-length transactions with unaffiliated parties. In addition, provision might be made for approval of such transactions by the disinterested members of the board of directors of the insurance company and, in the case of possible overreaching of its affiliate, the directors of

the affiliate. Of course, any proposal for legislation prohibiting self-dealing as part of S. 1710 might tend to dissuade insurance companies from voluntarily subjecting themselves to Federal regulation.

I trust that the foregoing responds adequately to your requests. If you need further information, please let me know.

Sincerely,

HAROLD M. WILLIAMS, *Chairman*.

The CHAIRMAN. Senator Sparkman.

Senator SPARKMAN. Thank you, Mr. Chairman.

Mr. Williams, I have been trying to read your statement in full. I must confess some parts of it seems to me to present a rather gloomy picture. I was looking, for instance, at your discussion of the *National Pacific* case, how it could maneuver as it did. What was done with reference to any enforcement against that particular company, for instance?

Mr. WILLIAMS. Well, in *National Pacific*, injunctive relief was rendered. The U.S. District Court for the District of Columbia appointed a receiver over National American Life, which was the company which was being abused. Under State law the Louisiana Insurance Commissioner placed National American Life in receivership, and we are now all working together under a stipulation whereby Louisiana and the receiver have assumed joint responsibility for the reorganization of the company. The litigation on the part of National American Life to recover what is due it is ongoing, and it's under the continuing cooperation of the receiver and the Commission subject to the jurisdiction of the Federal court in this district. So that there are, as I indicated, injunctions, and I believe in that case the U.S. district court, by consent, barred the people involved from being officers or directors of any public companies for up to 10 years.

Let me describe this more generically to you. What we try to do in these cases is obviously enjoin the activity and, when we have the kind of people involved in that injunction, to bar them from being officers of any public companies in the future and to require them to return the funds that they have absconded with. In some cases we have gotten really very extensive returns of such funds to the insurance company from which the funds came. We have called for restructuring of the boards of directors so we can bring some independent outside people in to try to reestablish a good, sound insurance company, and in certain cases appointed a receiver where there's a question of the solvency of a company.

Senator SPARKMAN. Now I notice that there was an equity receiver appointed over National American.

Mr. WILLIAMS. That's right.

Senator SPARKMAN. And the court ordered pursuant to a consent decree that \$1,100,000 be returned to National American. About \$835,000 has been returned and the control person of National Pacific has been held in contempt of court for failure to return the remainder. Does that just go by the board? Is there hope of paying up the balance of that?

Mr. WILLIAMS. I believe the substantive question there is whether he has the additional funds and whether we can find them. We haven't given up looking.

Senator SPARKMAN. Well, about all I can say is that I sympathize with you and your colleagues who have to try to untangle these things.

Mr. WILLIAMS. Senator, these cases become very complicated, and there's a real element of a shell game. As Senator Brooke intimated, we haven't found the only five cases in existence. That's obvious. Our sense of smell is not that good. So we must assume that there are more, and yet I don't know whether to be gloomy about it. You know, there are scoundrels in all industries, and I hate to blanket another industry with another level of regulation unless we know with a high level of confidence and have sustained the burden of proof that it's necessary.

Senator BROOKE. You can't do that with a six-man staff very well, could you?

Mr. WILLIAMS. No, sir.

Senator SPARKMAN. Well, thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Lugar.

Senator LUGAR. Chairman Williams, I would like to ask you some questions really just based on your overall lifetime of experience with money, securities, and business affairs. These are more broadly philosophical questions, but I'm intrigued by just this overall thought of what is likely to be the effect of a Federal plan such as presented in S. 1710 with regard to new entries into the insurance field. My general thought is simply that a prejudice, if I have one, is that it's likely to be an adverse situation, that since as you pointed out it may be a basic problem that lies with companies that are small now and that are overreaching and taking abnormal risks, as many companies will do when they are infant and trying to reach the bigger leagues, but does this concern you if the thing is to be an adverse reaction, that one effort of moving in this way may be to limit entry and therefore entrepreneurial situations in the insurance field?

Mr. WILLIAMS. I haven't focused on that. I can see the possibility. I don't know how to evaluate that. I could see that certainly that could happen.

Senator LUGAR. Some might say that is the inevitable course of almost all businesses in this country, that we are moving toward a concentration which relative few firms in any field finally exist and, on the other hand, when that happens, then the Federal policy becomes alarmed and suggests either an antitrust divestiture or any number of thoughts about how to scatter it out again.

My only purpose in raising the question at this point is to say it's during this type of consideration that sometimes we can compress firms into fewer and fewer and larger and larger because they are safer by and large to be seen, regulated, audited in a way in which the entry problem cannot.

Let me ask you this question. What is your overall reaction as you look at this legislation in terms of the cost-benefit ratio to maybe several entities? One, I suppose the general public in terms of any taxpayer funds that may finally get involved in this, or to the insurance industry as a whole, whether policyholders, investors or anybody who would be losing a good deal of money in the regulatory process trying to insure some other things?

My first reaction in listening to your testimony is that you may feel that by and large State regulatory authorities, the Federal Government to some limited extent, maybe the industry itself, have had some reasonable regulatory results that probably are less expensive than

what we are looking at now, but given the hazards of the course—and this is the reason for the consideration for the legislation—what is your first reaction as far as the overall cost-benefit ratio?

Mr. WILLIAMS. This will be a qualitative rather than a quantitative assessment. On a cost-benefit basis, I don't believe that the cost needs to be inordinate and that the balance could be pretty good between the cost and the benefit. My question is more a philosophical one than a cost-benefit one. I say it should be pretty good in the sense that if indeed the legislation, as I read it—and I don't know quite how all this would work—if indeed it would obviate the necessity for insurance companies to go to all 50 States, which is true on the part of some, for rate setting, that would be an attraction. They might well prefer to take chances in 50 States than to get a no answer in one jurisdiction. So maybe in some ways it may be more onerous, and in some ways it may become less onerous to the companies involved.

But in terms of cost, I can see some cost pluses. In terms of efficiency of the guarantee program, I can see some pluses there as well. In terms of the building up of the bureaucracy, I'd say with a pretty high level of confidence that it would build one and that it probably will exceed by a major order of magnitude the number of people that might become unemployed at the State regulatory agencies level; and it would certainly mean more people in the insurance companies as well. So I do see more people involved. I see the potential for some efficiencies from the insurance companies' standpoint. And I guess I'd say if we can indeed avoid the kinds of opportunities or reduce the likelihood of the kinds of opportunities that we have talked about in our enforcement cases, I think qualitatively speaking, without having to put a pencil to it, the cost-benefit balance isn't too bad. So I do come back to my first concern which is the philosophical concern: Whether we need blanket Federal regulation to deal with the problem that is not necessarily, as I would see it at this point, a generalized problem in the industry.

Senator LUGAR. But at least if you were weighing that here, is it fair to say you do not see an obvious or sort of an insuperable plus or minus to the thing? It's sort of in the margin as to how it might come out?

Mr. WILLIAMS. That's right.

Senator LUGAR. And I would just raise the question—and maybe the answer—for the record, that you also see and very frankly have stated that a fair number of people will be involved ultimately in doing this, and I mention this simply because it's during moments like this that agencies are created and that a substantial bureaucracy begins to occur and something disappears because the possibility of, it seems to me, ever unwinding all of this is probably remote, at least during our lifetimes. So I think this is an important consideration.

Let me ask one final question. Senator Brooke has mentioned in his opening statement and in testimony earlier in the Congressional Record severe problems of casualty insurance firms especially in 1974-75 and substantial losses during that period of time.

To what extent are these losses or are other problems faced by casualty insurers a question of the ethics and morality of our times? By that, I mean very aggressive claims pressed by many policyholders, sometimes bordering on fraud, sometimes fraud, simply a testing of

the system, and a very aggressive posture of really going after every last dollar? In other words, would any sort of regulation or guarantee that we're talking about today face up to that issue except maybe to suggest that greater rates, premiums or guarantees had to be imposed somewhere simply on a rough calculation as to the aggressiveness of the people searching for these claims?

Mr. WILLIAMS. Senator, I think it's an important question. Let me answer you this way. I think that the problem of the period in the early 1970's was a combination of several things which all came together to result in high underwriting losses and inadequate loss reserves—property casualty loss reserves. These resulted I think from several factors in turn. One is that in many cases strong State action to hold rate increases down kept the revenues down. On the loss side—the claims side—the impact of inflation and the tendency for claims to be litigated, which means in turn that the settlement period between the time that the claim arises and the time it's finally disposed of, has lengthened out enormously. Couple that with inflation and it means that the final settlement exceeds often by a large magnitude what the original claim estimate was. Add to that the fact that jury verdicts have gone through the roof. You put that all together and add to it the tendency in my judgment, of actuarial studies to really be driving through a rear-view mirror—in other words, actuarial studies extrapolate from the past. When the circumstances have changed from the original circumstances. Where inflation rates are higher, jury verdicts are higher, and the tail is longer on these claims, you can't use traditional actuarial assumptions to arrive at a reasonable claim loss reserve. Accordingly, the reserves are inadequate, and despite that, underwriting losses are too high. Then we put all these adverse factors together and squeeze them against the fact that you can write only a certain amount of insurance according to the amount of surplus. This creates all kinds of pressure to keep the earnings up, and there is a tendency not to not recognize the inadequacy of loss reserves, particularly when you can justify them by some actuarial study. These are problems that I think have to be dealt with really by the industry and by the accounting profession in conjunction with the industry. I'm not sure that having them federally regulated would have avoided the kinds of problems we saw in the 1973-74 period.

It's a long-winded answer. I'm sorry.

Senator LUGAR. I think it's a very important answer both from the standpoint of the State regulators not following up fast enough the inflationary spiral which continues and very special problems in the insurance field, the whole problem of arson now, people perhaps burning down their buildings trying to get settlements and liquidate a bad business there. All of this impacts upon what you're saying essentially, that these are areas in which the industry itself is going to have to grapple with some new assumptions, new actuarial ideas, and that the Federal situation we're looking at today probably would not have had a major influence on these difficulties which really are the root cause of these underwriting losses.

Mr. WILLIAMS. I think there's another piece of that that comes into play also, and that is that there are additional ratios, historic ratios, as to the amount of insurance you can write in relation to the surplus of the company. There's some question at least as to whether in view

of the whole inflationary trend there's adequate underwriting capacity. If that becomes a question I presume that the answer would be that the ratio of insurance written to surplus will grow. I believe that during the 1973-74 period it did indeed grow. I raise that as an important issue, however, suggesting a possible need for some uniform limits on the overall ratio between insurance and surplus. But I suspect that even if insurance were federally regulated, the regulators would not put a lid on by adopting ratios of this type and refusing to let the companies write additional insurance if there was a national need for more insurance.

Senator LUGAR. My time is up, but I think my observation would be the same as yours. With 6- to 10-percent inflation compounded forever, there are no ways to provide actuarial situations and insurance aside from what is being suggested now with social security, and that is tapping the general fund.

Thank you.

The CHAIRMAN. Mr. Chairman, I think this has been very helpful. Your responses have been most useful and the last interrogation by Senator Lugar is especially interesting. I'd just like to ask one other question.

Obviously, competition in this industry it seems to me is rather vigorous, at least that's my impression. I could be wrong. Competition should keep premiums reasonable under all the circumstances. I don't know of any and you haven't told us of any and perhaps there is some, but I don't know of any record of policyholders losing their coverage because of insurance companies going bellyup. The five cases you have given us—American Commonwealth, National Pacific which are related as you say, GEICO, Fisco, and Vanguard, apparently in none of those cases policyholders actually lost. I could be wrong about that. When you consider the fact that this is a several-hundred-billion-dollar industry, it's some of the great industries of this country, it seems to me that the record is a remarkably good one in terms of protection. As I say, I don't know of any substantial losses. Maybe there are some we don't know about and we ought to find out, but if there were I would think we would have people letting us know about that.

So, as I say, it's hard to see that there's a strong case for a substantial change in an industry that seems to be highly competitive, covering the needs of our country substantially, and without losses that I have seen documented.

Senator BROOKE. Would the Senator yield?

The CHAIRMAN. Yes.

Senator BROOKE. I agree with much of what the chairman has said, but you can't overlook what happened in the early 1970's. You can't overlook \$8 billion in underwriting losses. You can't overlook what could have occurred if one of these major companies, one of these giants, went under, and what the impact would have been on policyholders across this country. I don't think we have to wait until the horse gets out of the barn before we act. I think we have seen the warnings. I certainly hope it will never happen, and I'll do everything I can to prevent it, but you can't overlook that fact. Even though what the distinguished chairman has said is true, to my knowledge we haven't had any great losses, but we certainly could have had those

great losses. The same thing with the banking system. I believe that's why we have the FDIC. So I fail to see why that would mean that we should not legislate in this area.

The CHAIRMAN. Thank you very, very much, Mr. Chairman.

[The following additional material was received from the SEC for the record:]

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., February 14, 1978.

HON. EDWARD W. BROOKE,
U.S. Senate, Washington, D.C.

DEAR SENATOR BROOKE: In September 1977, I testified before the Committee on Banking, Housing and Urban Affairs concerning S. 1710, the proposed Federal Insurance Act of 1977. My written statement described several enforcement cases the Commission has brought against insurance companies in the past year. As I said at that time, the limited number of these cases against insurance companies makes it difficult to generalize about abuses. Accordingly, I thought it would be of assistance to bring you up to date on a recent Commission enforcement action with respect to an insurance company.

The Commission recently filed a complaint against Sierra Life Insurance Company,¹ which illustrates, not only alleged violations of the federal securities laws, but also the failure of Sierra to comply with state reporting requirements. Those reporting requirements are, of course, the predicate for the Section 12(g) (2) (G) exemption from the reporting requirements of the Securities Exchange Act of 1934 for insurance companies.

As described in more detail in the Commission's litigation release and complaint, copies of which are enclosed, the Idaho Insurance Commissioner ordered Sierra to divest itself of certain assets which did not conform to Idaho Insurance Code requirements. In connection with the sale of these assets, the chairman of the board and president of Sierra, and other defendants, allegedly engineered a premium sale of the directors' Sierra stock at a price of \$15 per share. Concurrently, Sierra agreed to sell 200,000 original shares of its stock to the same buyers at \$4.50 per share. The complaint, in addition to seeking an injunction, seeks disgorgement of profits from the officers and directors of Sierra who engaged in this transaction.

The Commission's complaint also alleges that the annual statements and supplemental documents for 1973 through 1976 filed with the state insurance authorities, as well as proxy materials and annual reports distributed to stockholders, contained false and misleading information concerning, among other things, officers' and directors' participation in material transactions in which Sierra was a party and the valuation of certain Sierra assets. Also alleged in the complaint is the fact that the Idaho insurance authorities were not fully informed as to material facts concerning Sierra.

I hope that this information will assist the Committee in its consideration of legislation concerning the insurance industry. If I can provide any further information, please let me know.

Sincerely,

HAROLD M. WILLIAMS, Chairman.

Enclosures.

[From SEC docket 1429]

LITIGATION RELEASE NO. 8260/JANUARY 18, 1978

S.E.C. v. SIERRA LIFE INSURANCE COMPANY, ET AL.

(D.C. Ida., Civil Action No. 78 1016)

Jack H. Bookey, Administrator of the Seattle Regional Office of the Securities and Exchange Commission, announced that on January 8, 1977, the Commission filed a complaint in the U.S. District Court of the District of Idaho, in Boise, seeking to enjoin Sierra Life Insurance Company, Greater Idaho Corporation, Fred M. Frazier, Lyle F. Frazier and Robert R. Nunnelley, all of Twin Falls,

¹ *SEC v. Sierra Life Insurance Company et al.* (D.C. Idaho, CA 78-1016).

Idaho, National Funding Corporation of Santa Ana, California, Powder Mountain Ski Corporation of Los Angeles, California, A. Bob Jordan and Dalbar Corporation, both of Oklahoma City, Oklahoma, Lucile H. McClintock of Pittsfield, Illinois, Lyle M. Jones of Hansen, Idaho, Carl D. Ettinger and Sandia Life Insurance Company, both of Albuquerque, New Mexico, Floyd Calvin Anglin of Burley, Idaho, John M. Driggers of Corona del Mar, California, John Hadley of San Clemente, California, Rudolph D. Lang of Las Vegas, Nevada, and Claude T. Rowe of Westminster, California, from further violations of the anti-fraud, reporting, and proxy provisions of the federal securities laws.

The complaint seeks an injunction against further violations of Section 17(a) of the Securities Act of 1933 and Sections 10(b), 13(a), 13(d)(1), 14(a), and 16(a) of the Securities Exchange Act of 1934 and Rules 10b-5, 13a-1, 13a-11, 13a-13, 13d-1, 14a-9, and 16a-1 thereunder. In addition the complaint seeks disgorgement of profits from certain officers and directors of Sierra, including the Frasers, Jones, and McClintock, and from others who acted in concert with them in engaging in fraudulent transactions involving sales of Sierra insider stock.

According to the complaint, the defendants began their violative conduct after the Idaho Insurance Commissioner ordered Sierra to divest itself of certain assets which did not conform to Idaho insurance code requirements. During the negotiations for the sale of these assets, which included the stock of Greater Idaho Corporation, a 12(g) Exchange Act subsidiary of Sierra, the chairman of the board and president of Sierra, Fred M. Frazier, and other defendants allegedly engineered a premium sale of the Sierra directors shareholdings of Sierra stock at a price of \$15 per share to the buyers of Sierra's Greater Idaho stock in December, 1974 concurrently with Sierra's agreement to sell 200,000 original shares of Sierra stock to the same buyers at a price of \$4.50 per share.

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF IDAHO

(Civil action—File No. 78-1016)

COMPLAINT FOR INJUNCTION AND ANCILLARY RELIEF

SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF,

v.

SIERRA LIFE INSURANCE COMPANY (AN IDAHO CORPORATION), SANDIA LIFE INSURANCE COMPANY (A NEW MEXICO CORPORATION), GREATER IDAHO CORPORATION (AN IDAHO CORPORATION), NATIONAL FUNDING CORPORATION (A CALIFORNIA CORPORATION), POWDER MOUNTAIN SKI CORPORATION (A COLORADO CORPORATION), DALBAR CORPORATION (AN OKLAHOMA CORPORATION), FRED M. FRAZIER, A. BOB JORDAN, CARL D. ETTINGER, LYLE F. FRAZIER, LYLE M. JONES, LUCILE H. MCCLINTOCK, ROBERT R. NUNNELLEY, FLOYD CALVIN ANGLIN, JOHN M. DRIGGERS, JOHN HADLEY, RUDOLPH D. LANG, AND CLAUDE T. ROWE, DEFENDANTS.

1. The Securities and Exchange Commission ("Commission") for its complaint alleges upon information and belief that the above-named defendants have engaged, are now engaging and are about to engage in acts and practices which constitute and will constitute violations, and the aiding, abetting, and causing of violations, of Section 17(a) of the Securities Act of 1933, as amended [15 U.S.C. 77q(a)], and Sections 10(b), 13(a), 13(d)(1), 14(a) and 16(a) of the Securities Exchange Act of 1934, as amended [15 U.S.C. 78j(b), m(a), m(d)(1), n(a), p(a)], and Rules 17 CFR 240.10b-5, 17 CFR 240.13a-1, 17 CFR 240.13a-11, 17 CFR 240.13a-13, 17 CFR 140.13d-1, 17 CFR 240.14a-9, and 17 CFR 240.16a-1 thereunder; and plaintiff, pursuant to Section 20(b) of the Securities Act of 1933, as amended [15 U.S.C. 77t(b)] and Sections 21(d) and 21(e) of the Securities Exchange Act of 1934, as amended [15 U.S.C. 78u(d) and (e)], brings this action to enjoin such acts and practices.

2. The defendants will, unless restrained, enjoined, and subjected to compliance orders of the Court, continue to engage in the acts and prices set forth in this complaint and acts and practices of similar purport and object.

3. This Court has jurisdiction of this action under Section 22(a) of the Securities Act of 1933, as amended [15 U.S.C. 77v(a)] and Section 27 of the Securities

Exchange Act of 1934, as amended (15 U.S.C. 78aa), as hereinafter more fully appears.

4. The acts, practices, transactions, and course of business constituting the violations alleged herein occurred and are occurring within the District of Idaho and elsewhere.

5. The defendant Sierra Life Insurance Company ("Sierra"), of Twin Falls, Idaho, was incorporated in Idaho on or about November 29, 1961. At all times since its incorporation Sierra has been engaged primarily in the business of selling and servicing life insurance contracts in Idaho and elsewhere, and investing and reinvesting the premium income it has received from such contracts in stocks, bonds, promissory notes, real estate, real estate contracts, real estate mortgages and trust deeds, and similar investments. From time to time prior to December 31, 1972 Sierra's only outstanding capital stock has consisted of shares of \$1 per share par value common voting stocks, of which there were 761,468 shares outstanding in the hands of approximately 6,200 shareholders residing in numerous states on that date. While the number of Sierra shareholders has remained at about this same level since 1973, Sierra now has 961,468 of its shares outstanding as the result of Sierra's issuance and sale of 200,000 additional shares of its stock to defendant National Funding Corporation ("National Funding," a California corporation whose last known place of business was located in Santa Ana, California) on or about December 18, 1974. The stock of Sierra has been regularly traded by use of the mails and the means and instrumentalities of interstate commerce over the past ten years or more.

6. The defendant Fred M. Frazier ("Frazier") is a resident of Twin Falls, Idaho. For more than the past ten years Frazier, sometimes acting with the assistance of one or more of the other defendants named herein, including but not limited to:

Names of defendant and relationship to Sierra

Carl D. Ettinger ("Ettinger"): Stockholder and director at all times since incorporation, and an officer since about April 1975;

Lyle F. Frazier: Stockholder and director from a time prior to 1973 to date hereof, and an officer since about April 1975;

John Hadley ("Hadley"): Stockholder (including undivided one-fifth interest in 200,000 shares about December 1974) and director at all times since about April 1975;

Lyle M. Jones ("Jones"): Stockholder and director at all times since incorporation, and an officer during 1973 and 1974;

A. Bob Jordan ("Jordan"): Attorney from a time prior to 1970 to date hereof, and mortgagor since late January 1975;

Rudolph D. Lang ("Lang"): Stockholder (undivided one-fifth interest in 200,000 shares about December 1974) and director from about December 19, 1974 to February 27, 1975;

Lucile H. McClintock ("McClintock"): Stockholder and director at all times since incorporation, and an officer during 1974, 1975 and 1976; and

Robert R. Nunnolley ("Nunnolley"): Stockholder, officer and director from a time prior to 1974 to date hereof; has continued to control, dominate and manage, directly and indirectly, the business affairs of Sierra, its subsidiary corporations, and other affiliated persons, and other corporations which were indebted to Sierra, primarily through his ownership of common stock of Sierra, its subsidiaries, and other corporations, and in his positions as an officer, director, chairman of the board of directors, and/or creditor of the foregoing corporations, including his position from time to time as a guarantor of the financial obligations of one or more of them.

7. Since about June 1972 defendant Greater Idaho Corporation ("Greater Idaho," an Idaho corporation organized in 1969) of Twin Falls, Idaho has had its 10¢ per share par value voting common stock registered with the Commission pursuant to Section 12(g)(1) of the Exchange Act, making the company, its officers, directors, and certain persons who then or thereafter held, acquired and/or disposed of its stock subject to the anti-fraud, filing and reporting requirements of Sections 13(a), 13(d)(1), 14(a) and 16(a) of the Exchange Act and the Commission's rules and regulations duly promulgated thereunder. The company has no other capital stock outstanding. As of June 30, 1976 the company had 58,588,782 shares of its stock outstanding in the hands of about 5,864 shareholders; and its assets, on a combined basis with its three wholly owned subsidiaries, including

Regal Manufacturing Company ("Regal"), were valued by the company at more than \$10 million.

8. Greater Idaho was a majority-owned (58% or more) subsidiary of Sierra from 1969 until about June 6, 1974, when Sierra contracted to sell all of its Greater Idaho stock to Best National Enterprises, Inc. ("Best National") of Chicago, Illinois. Sierra regained operating control of Greater Idaho from Best National about October 29, 1974 after it became apparent to Sierra that Best National would soon be in default with respect to the latter's contract to purchase the Greater Idaho stock. When the default occurred on December 16, 1974, Sierra, which since about June 6, 1974 had retained the Greater Idaho stock on a pledge from Best National, foreclosed the pledge and claimed beneficial ownership of the shares.

9. Defendant Powder Mountain Corporation ("Powder Mountain") is a Colorado corporation which maintains its principal office in Los Angeles, California. About December 18, 1974 Powder Mountain, acting as nominee for a five-man joint venture composed of defendants Floyd Calvin Anglin ("Anglin"), John M. Driggers ("Driggers"), John Hadley ("Hadley"), Rudolph D. Lang ("Lang"), and Claude T. Rowe ("Rowe"), contracted to purchase Sierra's stock in Greater Idaho. These five men, hereinafter sometimes referred to as the "Powder Mountain group," cause themselves to be elected officers and directors of Greater Idaho and thereafter continuously occupied the same or similar positions, as indicated:

Name of defendants and subsequent relationship to Greater Idaho

Anglin: Director and an officer at all times since about December 18, 1974;

Driggers: Director at all times since about December 18, 1974, and an officer from that date to about mid-1976;

Hadley: Director at all times since about December 18, 1974, and an officer from that date until November 1975 or thereafter;

Lang: Director and an officer from about December 18, 1974 to mid-1976; and

Rowe: Director and an officer at all times since about December 18, 1974.

The defendant Jordan was the recording secretary of Greater Idaho during 1975, and he has been a director of Greater Idaho and its various subsidiaries since about March 13, 1975.

10. The defendant Dalhar Corporation ("Dalhar," an Oklahoma corporation whose last known place of business was located in Tustin, California) was organized in March 1975 by Jordan, who was acting in behalf of the Powder Mountain group, primarily for the purpose of placing in Dalhar most of the assets and liabilities of the Powder Mountain group which had been acquired or incurred by its members and its nominee corporations, Powder Mountain and National Funding, during November and December 1974 in the course of contracting to purchase from Sierra 200,000 shares of Sierra stock and Sierra's control stock in Greater Idaho and Western Skies Corporation ("Western Skies," a New Mexico corporation engaged in the motel business in Albuquerque), and in contracting to purchase at \$15 or more per share a total of 141,000 shares of Sierra stock from Frazier, Jones, McClintock, Lyle F. Frazier, Clarence M. Chick ("Chick," a director of Sierra immediately prior to December 19, 1974) of Twin Falls, Idaho, Glenda McGreer ("McGreer," who was then Frazier's personal secretary) of Twin Falls, Idaho, and Robert E. Veeh, ("Veeh," who was and is a son-in-law of Frazier) of Twin Falls, Idaho. Dalhar acquired the foregoing assets and liabilities about April 1975, making it the parent corporation of Greater Idaho, a position which it has retained to the present. At all times since 1972 Frazier has been the next to the largest holder of Greater Idaho's common stock, holding nearly 2 million shares of the stock throughout this period.

11. The defendant Sandia Life Insurance Company ("Sandia," a New Mexico corporation which is managed from the Twin Falls, Idaho office of Sierra), is a wholly-owned subsidiary of Sierra which the latter organized in December 1975 (with assets stated as of December 31, 1975 in the amount of \$10,426,436, liabilities \$9,722,817, capital \$200,000 and surplus \$503,619) and which Sierra has used since that time principally to hold and service insurance contracts which Sierra and its predecessors in interest had entered into with persons who were not residents of Idaho, and to hold and manage those assets which Sierra had contracted to purchase in November and December 1974 from the Powder Mountain group. Since its inception, the officers and directors of

Sandia have been persons who also were officers and/or directors of Sierra, including Ettinger, Frazier, Hadley, Jones, McClintock, Nunnelley, and Lyle F. Frazier.

12. From a time prior to 1966, defendant Jordan has continued to be a lawyer residing in Oklahoma City, Oklahoma. In numerous occasions since about mid-1966 he has provided legal advice and other legal services to Frazier, Sierra, Dalhar, Sandia, Greater Idaho, Powder Mountain, National Funding, their subsidiaries, officers, directors, and other affiliated persons, including the Powder Mountain Group, and Idaho Investment Corporation (a corporation enjoined by the court in August 1966 from further violations of the registration and anti-fraud provisions of federal securities laws in *S.E.C. v. Idaho Investment Corporation and Fred M. Frazier*, Civ. File No. 1-6-69, and which was merged into Greater Idaho in late 1972 through the efforts of Frazier and Jordan), many of which services Jordan provided while he was physically present within the District of Idaho.

13. Defendant Anglin is a resident of Burley, Idaho, and he transacts business in that state.

14. Defendant Driggers is a resident of Corona del Mar, California.

15. Defendant Ettinger is a resident of Albuquerque, New Mexico who transacts business in Idaho as a stockholder, officer and/or director of Sierra and Sandia.

16. The defendants Lyle F. Frazier, Jones and Nunnelley are residents of Twin Falls, Idaho. Lyle F. Frazier is the son of defendant Frazier.

17. Defendant Hadley is a resident of San Clemente, California who transacts business in Idaho.

18. Defendant Jones is a resident of Kimberly, Idaho.

19. Defendant Lang is a resident of Las Vegas, Nevada who transacts business in California.

Defendant McClintock is a resident of Pittsfield, Illinois who transacts business in Idaho as a stockholder, officer and/or director of Sierra and Sandia.

21. Defendant Rowe is a resident of Westminster, California who transacts business in Idaho.

COUNT I

Section 17(a) of the Securities Act of 1933

[15 U.S.C. 77g(a)]

Section 10(b) of the Securities Exchange Act of 1934

[15 U.S.C. 78j(b)]

Rule 17 CFR 240.10b-5

22. Paragraphs 1 through 21 are hereby realleged and incorporated herein by reference.

23. Since about August 1973 the defendants, singly and in concert, and aiding, abetting, and causing each other to engage in the following conduct, have been and now are, by use of means and instruments of transportation and communication in interstate commerce and the mails, in the offer and sale of the common stock of Sierra, Greater Idaho, Western Skies, and United Industries, and bonds and promissory notes of various issuers, and in connection with purchases and sales of those securities, on the open market and otherwise, directly and indirectly, employing devices, schemes, and artifices to defraud existing and prospective owners of those securities (hereinafter collectively referred to as "investors," which includes, among other persons, brokers and dealers who effected, and those who gave consideration to effecting, transactions in Sierra and Greater Idaho stock), making untrue statements of material facts to investors and omitting to state to them material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, and engaging in fraudulent, manipulative, and deceitful acts, practices, transactions, and a course of business which would and did operate as a fraud and deceit upon the investors, as more particularly described in paragraphs 24, 25 and 26 of this Court.

24. As a part of the defendants' conduct described in paragraph 23 above, the defendants aided, abetted and caused each other to engage in various manipulative, deceitful and fraudulent acts and practices, including but not limited to those acts and practices described in paragraphs 25 and 26 hereof, and in those set forth below:

A. On or about June 7, 1974 Frazier, aided and abetted by Sierra, Greater Idaho, Ettinger, Nunnolley, and Jordan, caused Greater Idaho to convey to Frazier free and clear title to approximately 16 blocks of land, and an additional 176 lots of land, all in Antelope Valley Subdivision Units A and B located in Custer County, Idaho for which Frazier gave little or nothing of value in exchange;

B. During November and December 1974 the Powder Mountain group, aided and abetted by Sierra, Frazier, Jordan, Jones, Lyle F. Frazier, McClintock, Ettinger, Nunnolley, Powder Mountain, National Funding, Chick, McGreer, and Veeh, contracted to acquire control of Sierra from and through Frazier and Chick by entering into contracts for the purchase of 141,000 shares of personally-owned Sierra stock at a price of \$15 or more per share, the foregoing defendants well knowing at the time that the contracts to purchase the personally-owned shares were part of a fraudulent plan and scheme contrived by the defendants and others which required and caused the Powder Mountain group to purchase from Sierra 200,000 shares of its original issue stock at a price of \$4.50 per share, plus Sierra's stock interests in Greater Idaho and Western Skies, in exchange for assets of doubtful value in the form of bonds, notes, real estate mortgages and trust deeds, and stock of United Industries, Inc. ("United Industries," an Idaho corporation).

C. Commencing about December 1974, in connection with Sierra's sale of 200,000 shares of its original issue stock to the Powder Mountain group, Frazier, aided and abetted by Jordan, Anglin, Driggers, Hadley, Lang, and Rowe, claimed and thereafter held the 200,000 shares as a pledge to himself from the Powder Mountain group to secure payment of his December 30, 1974, executory contract to sell 124,000 shares of Sierra stock to the Powder Mountain group at \$15 per share, notwithstanding the foregoing defendants then knew or had reason to believe that Frazier was not lawfully entitled to receive and hold the shares as pledged for his own account.

D. During the period from about June to October, 1975, Sierra, Dalhar, and Greater Idaho, aided and abetted by the other defendants, made and caused other persons to make oral and written statements to representatives of the Idaho department of insurance which defendants then knew or had reason to believe were false and misleading as to material facts concerning the capabilities of Greater Idaho and Dalhar to satisfy the obligations they then owed to Sierra, and as to the fair value of Sierra's admitted assets as of December 31, 1974.

E. In December 1975 Frazier, aided and abetted by the other defendants, improperly claimed and thereafter held as beneficial owner the 200,000 shares of Sierra stock described in subparagraph C above, as the foregoing defendants then well knew or had reason to believe.

25. As a further part of the defendants' conduct described in paragraph 28 above, and to conceal material facts from investors, state insurance authorities, and others, the defendants aided, abetted and caused Sierra to distribute by mail to investors, state insurance authorities, and other persons copies of the following documents:

Sierra's annual statements and supplemental documents for 1973 through 1976 filed with state insurance authorities;

Sierra's notice of annual stockholders' meetings, and related proxy material which included Sierra's annual report to stockholders for the preceding year;

A confidential report to policyholders of Sierra which was distributed to Sierra stockholders and policyholders in March 1976;

A report to Sierra stockholders dated September 1, 1977, and sent to them in October 1977, which contained false and misleading statements of material facts, among others, to the following effect:

A. The year 1973 was one of continued financial progress for Sierra; whereas, in fact, as defendants omitted to disclose, in August 1973 Sierra had been ordered by Idaho insurance authorities to dispose of approximately 40 percent of its assets because there was a serious doubt in the minds of state insurance authorities as to the admissibility of those assets for insurance reserve purposes.

B. During the preceding year no officer or director of Sierra had any material interest, direct or indirect, in any material transaction to which Sierra was or would be a party; when in fact, as defendants omitted to disclose, the defendant Frazier had engaged in such transactions to his profit and benefit during 1970, 1972, 1974, 1975, and 1976, and the defendants Lyle F. Frazier, Jones and McClintock, together with Chick, had engaged in such transactions to their profit and benefit during 1974 and 1975.

c. The December 1974 sale of Sierra's interests in Greater Idaho and Western Skies to the Powder Mountain group allowed Sierra to greatly enhance its holdings of high yield investments, particularly bonds and mortgages, when in truth and in fact, as defendants omitted to disclose:

(1) the assets which Sierra had received in exchange from the Powder Mountain group were assets of doubtful value to Sierra because they could not be sold on the open market in the foreseeable future at prices near or in excess of the values at which Sierra reflected them on its books and records;

(2) the Powder Mountain group, its members, and their nominee companies were not financially capable of performing their contractual obligations to Sierra at any time in the foreseeable future;

(3) Sierra's December 1974 transactions with the Powder Mountain group had caused or would cause Sierra to make in excess of \$1 million in loans to members of the Powder Mountain group and their affiliated companies during late 1974, and in 1975, to prevent their financial collapse and to provide them with funds for various purposes, including funds to make partial payments for personally-owned shares of Sierra stock which the Powder Mountain group had contracted to purchase from Frasier, Lyle F. Frasier, Jones, McClintock, Chick, McGreer, and Veeh in December 1974.

D. All assets acquired by Sierra after June 30, 1973 had been specifically approved by the Idaho director of insurance without qualification prior to such acquisitions; whereas in truth and in fact, as defendants omitted to disclose, in those cases where such approval was given, the director was not fully informed, nor thereafter made and kept fully informed, as to all material facts connected with a given acquisition.

E. Sierra was a financially sound life insurance company because the value of its admissible assets substantially exceeded the combined total of its liabilities and capital, and the same was true as to the financial condition of Sandia; when in truth and in fact, as the defendants omitted to disclose:

(1) there was a substantial risk that Sierra and Sandia were insolvent or on the verge of insolvency;

(2) other defendants had unjustly enriched themselves at the expense of Sierra and its public shareholders;

(3) The annual statements of Sierra and Sandia reflected admitted assets which did not qualify as such and/or were substantially over-stated as to the value thereof.

(4) Other defendants had engaged in conduct which resulted in Sierra and Sandia receiving documents of title and transfer of title to assets, which documents had been substantially back-dated and/or executed by persons other than those who purportedly did so, or were otherwise executed by persons who lacked legal authority to do so;

(5) Sierra and Sandia had made and would make loans to other defendants and their affiliated persons under circumstances where there was a substantial risk that the principal and interest on the loans would not be paid when due;

F. In connection with the many transactions which, directly or indirectly, stemmed from the Idaho insurance department order of several years ago requiring Sierra to dispose of about 40% of its assets, the management personnel of Sierra acted at all times with complete propriety and in the utmost good faith, kept Sierra's stockholders fully informed as to all material facts, and unselfishly fulfilled their fiduciary obligations and duties to Sierra, its policyholders and stockholders; when in fact, as defendants omitted to disclose, they had engaged in and/or aided, abetted or caused the conduct described in subparagraphs A through E immediately above, and in paragraphs 24 and 26 hereof.

26. As a further part of the defendants' conduct described in paragraph 23 above, and to conceal from investors, the Commission, state insurance authorities, and other persons, undisclosed material facts of the types referred to in paragraph 25 above and the manipulative, deceitful and fraudulent acts and practices described in paragraph 24 above, the defendants, during the period from about November 18, 1974 to the date of the filing of this complaint, aided, abetted and caused various defendants to file false and misleading reports and proxy material with the Commission, and caused various defendants to fail to file with the Commission reports concerning their business affairs as required by Sections 13(a), 13(d)(1), and 16(a) of the Securities Exchange Act of 1934 and Rules thereunder, including but not limited to those reports and proxy material described in Counts II, III and IV of this Complaint.

COUNT II

Sections 13(a) and 13(d)(1) of the Securities Exchange Act of 1934

[15 U.S.C. 78m(a) and 78m(d)(1)]

Rules 17 CFR 240.13a-1, 13a-11, 13a-13, 13d-1

27. Paragraphs 1 through 21, and 24 through 26 are hereby realleged and incorporated herein by this reference.

28. Since about September 30, 1974, Greater Idaho, Sierra, Dalhar, National Funding, Powder Mountain, and Frazier, aided and abetted by the other defendants, have violated and continued to violate Sections 13(a) and 13(d)(1) of the Securities Exchange Act of 1934 and Rules 13a-1, 13a-11, 13a-13, and 13d-1 thereunder in the following respects, among others:

Violations of Rule 13a-1

GREATER IDAHO

(1) Filed a substantially misleading (and about 50 days late) Form 10-K on November 18, 1974 for the fiscal year ending June 30, 1974 inasmuch as the report, among other things, failed to disclose material facts related to Greater Idaho's transfer of land in Antelope Valley, Ouster County, Idaho to Frazier in June 1974;

(2) Filed about September 30, 1977 Form 10-Ks for its fiscal years ending June 30, 1975 and June 30, 1976, which contained unaudited financial statements and which were filed a year or more late.

(3) Failed to file on or before the September 28, 1977 due date or thereafter a Form 10-K report for its fiscal year which ended June 30, 1977.

Violations of Rule 13a-11

GREATER IDAHO

Failed to file Form 8-Ks, as indicated below:

(1) January 1975 to reflect Sierra's reacquisition of Greater Idaho's control stock from Best National on or about December 16, 1974 and Powder Mountain's acquisition of this stock from Sierra on or about December 18, 1974;

(2) May and/or June 1975 to reflect Greater Idaho's acquisitions of Sierra stock from National Funding, and Dalhar's acquisition of Greater Idaho control stock from Powder Mountain;

Violations of Rule 13a-13

GREATER IDAHO

Failed to file Form 10-Qs for fiscal year quarters, as indicated below:

(1) September 30, 1975; (2) December 31, 1975; (3) March 31, 1976; (4) September 30, 1976; (5) December 31, 1976; (6) March 31, 1977; and (7) September 30, 1977;

Violations of Rule 13d-1

GREATER IDAHO

Failed to file a Schedule 13D in May and/or June 1975 or thereafter reporting its April and/or May 1975 acquisitions of shares of Sierra stock;

SIERRA

Failed to file a Schedule 13D within ten days after about December 16, 1974, or at any time thereafter, reporting its acquisition of more than 5% of Greater Idaho's outstanding common stock from Best National on or about that date;

DALHAR

Filed a false and misleading Schedule 13D on or about April 15, 1975 concerning its acquisition of more than 5% of Greater Idaho's outstanding common stock from Powder Mountain in that the report failed to disclose the stock was pledged to or deposited with Sierra pursuant to a contract, arrangement or understanding with the latter company;

NATIONAL FUNDING

Failed to file a Schedule 13D within ten days after December 19, 1974 or at any time thereafter reporting its acquisition of more than 5% of Sierra's outstanding stock about December 19, 1974;

POWDER MOUNTAIN

Filed a false and misleading Schedule 13D about December 30, 1974 in reporting its acquisition of more than 5% of the outstanding common stock of Greater Idaho on December 18, 1974 in that it failed to disclose that it had pledged or deposited the stock with Sierra pursuant to a contract, arrangement or understanding with the latter company;

FRAZIER

Failed to file a Schedule 13D within ten days after December 29, 1975 or at any time thereafter reporting his acquisition of more than 5% of Sierra's outstanding common stock from Greater Idaho on or about that date.

COUNT III

Section 14(a) of the Securities Exchange Act of 1934 [15 U.S.C. 78n(a)]
Rule 17 CFR 240.14a-9

29. Paragraphs 1 through 21, 24 through 26, and 28 are hereby realleged and incorporated herein by this reference.

30. On or about April 25, 1975 Greater Idaho, aided and abetted by Jordan, Anglin, Driggers, Hadley, Lang, and Rowe solicited proxies from its shareholders for voting its common stock by mailing to its stockholders a notice of annual meeting to be held May 6, 1975 and related proxy material soliciting proxies for the purpose of electing a board of directors for the company, which material contained statements which, at the time and in light of the circumstances under which they were made, were false and misleading with respect to material facts, and which material omitted to state material facts necessary in order to make the statements therein not false or misleading, in that, among other things, the material made statements to the following effect:

A. It was anticipated that the curing by Dalhar of certain title defects pertaining to two mortgages which Dalhar, as successor to Powder Mountain, had agreed to transfer to Sierra would be resolved in the near future with a resulting release by Sierra to Dalhar of the Greater Idaho control stock held by Sierra;

B. Dalhar retained voting rights to the 20,318,162 shares of Greater Idaho stock which Sierra held as a security deposit;

C. The proxies being solicited would be used to vote for Anglin, Driggers, Hadley, Jordan, Lang and Rowe as members of the new board of directors;

D. Copies of Greater Idaho's annual report as of June 30, 1974 had been sent to shareholders of record in March 1975;

E. Greater Idaho's certified public accountants would have representatives at the meeting who would be available to shareholders for proper questions, but omitted to state various matters of material fact, including but not limited to those described in paragraphs 24 through 26, and 28, which were then known to the foregoing defendants, and which were necessary to be made known to the shareholders who received the proxy material in order to make the statements made therein not false or misleading.

COUNT IV

Section 16(a) of the Securities Exchange Act of 1934

[15 U.S.C. 78p(a)]

Rule 17 CFR 240.16a-1

31. Paragraphs 1 through 21, and 24 through 26 are hereby realleged and incorporated herein by this reference.

32. Since about December 18, 1974, Sierra, Dalhar, and Powder Mountain, aided and abetted by each other and by the other defendants, have violated Sec-

tion 16(a) of the Securities Exchange Act of 1934 and Rule 16a-1 thereunder in the following respects:

SIERRA

(1) Failed to file a Form 8 within ten days after about December 16, 1974, or at any time thereafter, reflecting its acquisition on or about that date of more than 10% of Greater Idaho's outstanding common stock;

(2) Failed to file a Form 4 within ten days after about December 18, 1974, or at any time thereafter, reflecting its disposition of the same stock;

POWDER MOUNTAIN

Failed to file a Form 4 within ten days after about April 10, 1975, or at any time thereafter, to reflect its disposition of Greater Idaho stock on or about that date;

DALHAN

Failed to file a Form 8 within ten days after about April 10, 1975, or at any time thereafter, reflecting its acquisition of more than 10% of Greater Idaho's outstanding common stock about that date.

Wherefore the plaintiff Commission respectfully demands:

I

Judgments of preliminary and permanent injunction restraining and enjoining the defendants, their officers, agents, servants, attorneys, employees, and those persons in active concert or participation with them who receive actual notice of any such judgments by personal service or otherwise from:

A. In the offer or sale of any security issued by Sierra Life Insurance Company, Greater Idaho Corporation, or any other security, or in connection with the purchase or sale of any such securities, by use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly, making any untrue statements of a material fact or omitting to state any material facts necessary in order to make any statements made, in the light of the circumstances under which any such statements were made, not misleading or engaging in any other fraudulent or deceitful transaction, act, practice or course of business prohibited by Section 17(a) of the Securities Act of 1933 (15 U.S.C. 77q(a)), or Section 10(b) of the Securities Exchange Act of 1934, as amended (15 U.S.C. 77j(b)), and Rule 10b-5 thereunder (17 CFR 240.10b-5).

B. Aiding, abetting, inducing, commanding, or counseling any other person to engage in any of the types of conduct described in paragraph A above.

II

Judgments of preliminary and permanent injunction:

A. Requiring Greater Idaho promptly to file a Form 10-K with the Commission pursuant to Section 13(a) of the Securities Exchange Act of 1934 and Rule 13a-1 thereunder for its fiscal year ended June 30, 1977 which contains financial statements prepared and certified as to their accuracy and completeness without any qualification, limitations, restrictions, or reservations by an independent certified public accountant, and prohibiting Greater Idaho from failing to file Form 10-Ks with the Commission on a timely basis for all subsequent fiscal years as to any of its securities in accordance with the requirements of said section and rule;

B. Requiring Greater Idaho promptly to file Form 10-Qs with the Commission pursuant to Section 13(a) of the Securities Exchange Act of 1934 and Rule 13a-13 thereunder for those quarters which ended September 30, 1975, December 31, 1975, March 31, 1976, September 30, 1976, December 31, 1976, March 31, 1977, September 30, 1977, and prohibiting it from failing to file Form 10-Q reports with the Commission on a timely basis for all succeeding quarters as to any of its securities in accordance with the foregoing section and rule;

C. Requiring Greater Idaho promptly to file Form 8-Ks with the Commission pursuant to Section 13(a) of the Securities Exchange Act of 1934 and Rule 13a-11 thereunder, for the months and transactions indicated:

(1) December 1974 to reflect Sierra's acquisition of Greater Idaho control stock from Best National on or about December 16, and Powder Mountain's acquisition of the control stock from Sierra on or about December 18;

(2) April and/or May 1975 to reflect Greater Idaho's acquisitions of 200,000 or more shares of Sierra common stock from National Funding, and Dalhar's acquisition of the Greater Idaho control stock from Powder Mountain during that period; and prohibiting Greater Idaho from failing to file Form 8-Ks with the Commission on a timely basis in the future as to any of its securities in accordance with said section and rule;

D. Requiring Greater Idaho, Sierra, Dalhar, National Funding, Powder Mountain, and Frazier promptly to file Schedule 13Ds with the Commission pursuant to Section 13(d)(1) of the Securities Exchange Act of 1934 and Rule 13d-1 thereunder with respect to the following acquisitions of securities:

(1) Sierra, as to its acquisition of approximately 59% of Greater Idaho's common stock from Best National in December 1974;

(2) National Funding, as to its acquisition in December 1974 of approximately 200,000 shares of Sierra common stock directly from Sierra;

(3) Greater Idaho, as to its acquisition in April or May 1975 of 200,000 or more shares of Sierra common stock from National Funding;

(4) Frazier, as to his acquisition of the same 200,000 or more shares of Sierra stock from Greater Idaho about December 1975, and prohibiting the foregoing defendants from failing to file timely Schedule 13Ds with the Commission as to the securities of any issuer in the future in accordance with the requirements of said section and rule;

E. Requiring Dalhar and Powder Mountain promptly to file Schedule 13Ds with the Commission pursuant to Section 13(d)(1) of the Securities Exchange Act of 1934 and Rule 13d-1 thereunder which are not false or misleading with respect to their following acquisitions of securities:

(1) Powder Mountain, as to its acquisition of approximately 59% of Greater Idaho's outstanding common stock from Sierra about December 18, 1974;

(2) Dalhar, as to its acquisition of approximately 59% of Greater Idaho's outstanding common stock from Powder Mountain about April 10, 1975; and prohibiting the foregoing defendants from filing false or misleading Schedule 13Ds with the Commission as to any securities of any issuer in the future contrary to the requirements of said section and rule.

III

Judgments of preliminary and permanent injunction against Greater Idaho prohibiting it from making any solicitation by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in light of the circumstances under which it was made, is false and misleading with respect to any material fact, or which omits to state any material fact necessary in order to make any statement made therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading, concerning but not limited to:

A. the past, present, or anticipated financial condition and results of operations of Greater Idaho or any other person;

B. the past, present, or anticipated business operations of Greater Idaho or any other person;

C. the contracts or agreements to which Greater Idaho or any other person was, is, or may be a party in interest;

D. the business experience, skill, success, integrity, or candor of any officer, director, or other affiliated person of Greater Idaho or any other person, at any time when Greater Idaho has securities registered with the Commission pursuant to Section 12 of the Securities Exchange Act of 1934.

IV

Judgments of preliminary and permanent injunction:

A. Requiring Sierra to file a Form 3 with the Commission to show its acquisition of more than 10% of Greater Idaho's outstanding common stock from Best National about December 16, 1974 and a Form 4 to reflect its resale of the same stock to Powder Mountain about December 18, 1974, pursuant to Section 16(a) of the Securities Exchange Act of 1934 and Rule 16a-1 thereunder, and prohibiting Sierra from failing to file timely Form 3s and Form 4s with the Commission as to the securities of any issuer in the future in accordance with the requirements of said section and rule;

B. Requiring Powder Mountain to file a Form 4 with the Commission to reflect its disposition of Greater Idaho stock to Dalhar about April 10, 1975 pursuant to Section 16(a) of the Securities Exchange Act of 1934 and Rule 16a-1 thereunder, and prohibiting Powder Mountain from failing to file timely Form 8s and Form 4s with the Commission as to the securities of any issuer in the future in accordance with the requirements of said section and rule;

C. Requiring Dalhar to file a Form 3 with the Commission to show its acquisition of more than 10% of Greater Idaho's outstanding common stock about April 10, 1975, pursuant to Section 16(a) of the Securities Exchange Act of 1934 and Rule 16a-1 thereunder, and prohibiting Dalhar from failing to file timely Form 8s and Form 4s with the Commission as to the securities of any issuer in the future in accordance with the requirements of said section and rule.

V

Judgments of preliminary and permanent injunction against all the defendants prohibiting them from aiding and abetting any of the acts and omissions which would be prohibited by the judgments demanded in Sections II through IV above.

VI

An order requiring Frazier to disgorge all profits he made in connection with his acquisition and disposition of land in Antelope Valley Subdivision, Units A and B, Custer County, Idaho, which he obtained from Greater Idaho on or about June 7, 1974.

VII

An order requiring Frazier, Jones, Lyle F. Frazier, and McClintock to disgorge all of the profits they obtained directly or indirectly as a result of the contracts they entered into about December 1974 or thereafter to sell their personally-owned shares of Sierra stock to the Powder Mountain group.

VIII

An order requiring Frazier to disgorge the 200,000 shares of Sierra stock which he obtained, directly or indirectly, from the Powder Mountain group, National Funding, Dalhar and/or Greater Idaho purportedly as additional collateral to secure the performance of his agreement of December 30, 1974 to sell 124,000 shares of his Sierra stock to National Funding.

IX

An order requiring Sierra to take whatever steps are reasonably necessary and appropriate to recover the profits obtained by Chick, McGreer, and Veeh through contracts they entered into, directly or indirectly, in 1974 or thereafter to sell shares of their Sierra stock to the Powder Mountain group, National Funding, Dalhar and/or Greater Idaho.

X

Such other and further relief as the Court may determine to be just and equitable.

KARL M. SHURTLEIFF,

U.S. Attorney

of Attorneys for Plaintiff.

JACK H. BOOKEY,

LANE B. EMORY,

GERALD G. CUNNINGHAM,

CHRISTOPHER B. WELLS,

Attorneys for Plaintiff,

Securities and Exchange Commission.

Our next witness is the Deputy Federal Insurance Administrator, John Robert Hunter, Jr. Now I'd also like to have Mr. Sims come forward at the same time, if we could, so we could have a panel. Mr. Sims is Deputy Assistant Attorney General, Antitrust Division.

We are honored and happy to have both of you gentlemen. We would appreciate it if you could follow the superlative example of the

preceding witness and boil your statements down, if possible, to 10 minutes because we have a number of questions we would all like to get into, if possible. Mr. Hunter, go right ahead. Incidentally, if you do that, we will have your statement printed in full in the record.

STATEMENT OF JOHN ROBERT HUNTER, JR., DEPUTY FEDERAL INSURANCE ADMINISTRATOR, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, ACCOMPANIED BY HOWARD CLARK, FORMER INSURANCE COMMISSIONER, SOUTH CAROLINA

Mr. HUNTER. I have with me today Mr. Howard Clark, who is a former insurance commissioner of South Carolina and an expert on insurance regulatory matters from both State and Federal viewpoints.

Let me make it plain at the very outset that we regard Senator Brooke's bill as one of the most significant contributions in the long dialog respecting State-Federal relationships referable to the regulation of insurance. The bill is unique in that it removes the dialog from the abstract and places it in the concrete setting of real problems which call for practical solutions. Senator Brooke has performed a real public service in introducing the measure, and your committee performs a similar service in providing this public forum.

In introducing this revision of the original bill, Senator Brooke has indicated his primary intention of fostering and furthering debate on the subject, particularly with respect to the concept of affording insurers an election whether to be regulated at the State level or to be regulated, in part, at the Federal level. We wholeheartedly agree with the wisdom of avoiding any suggestion that either the concept or the terms of the bill have been carved into granite. Much debate, great consideration, and further refinement are needed before we can even begin to consider the provisions of the measure as relatively fixed. Indeed, as Senator Brooke has himself stated, it may be that the conceptual design of the bill will have to be abandoned as unworkable, though we are far from predicting any such result.

There are two clearly separate concepts within the bill, the Federal chartering or dual regulation concept, and the solvency guarantee provisions. We shall focus primarily on the solvency protection features of the bill.

It is evident that the seed of the bill was planted when the insurers voiced their concern over the ripple effects stemming from the prospective insolvency of a major insurer—which fortunately did not come to pass—under the post-assessment features of the NAIC Model Act which makes provision for the assessment of participating insurers only after the occurrence of an insolvency. The insurers' understandable concern in this regard was exacerbated by the actual failure of the Gateway which constituted the largest failure of a single insurer in property-liability insurance history.

Under the present bill, the Federal solvency guaranty mechanism is open to all insurers who meet and comply with its standards, and such insurers thereby are immunized from participation in the State entities. We believe that this may well intensify the adverse selection factor and cast further doubts upon the ability of State guaranty mechanisms to survive. This matter is worthy of the committee's

closest consideration, and it may be that thought may need to be given to the desirability of preemption.

Mr. Chairman, the unfortunately long history of tight insurance markets and perennial insurance crises has been replete with examples of insurance interests taking advantage of the situation to amass volumes of business which they had neither the finances nor the will to absorb. In short, in too many instances, there emerged companies that were "formed to go broke." This is not at all intended to suggest that all, or even many, of the insurers specializing in so-called high-risk insurance are, or have been, predators, but the fact is that the history of insurer failures is filled with disasters wrought by those who were predators, optimists to a fault, or an unhappy combination of the two.

Legislators and regulators at the State level beset by the political reverberations from a vagarious insurance market sometimes succumbed to the temptation to look the other way when danger signals flashed.

Successive crises—or problems, if you prefer—in the medical malpractice, products liability, and other general liability lines of insurance suggests that market problems aplenty now exist, and that desire for relief from those problems is widespread.

In the light of the recent failure of an insurer which transacted the majority of its business as a surplus lines insurer engaged in miscellaneous liability business, we are frankly concerned that the NAIC Model Act and other State statutes that we have reviewed provide no relief to policyholders or seriously injured claimants of an insolvent surplus lines insurer. As we read the Model Act, it appears that if a surplus lines insurer issues its policies in a State other than that of its domicile, neither the guaranty association of the foreign State nor the guaranty association of the insurer's domicile will cover the claim of a seriously injured resident of the foreign State in the event of the insolvency of the surplus lines insurer.

As to the foreign State, section 4(a) of the Model Act defines an "insolvent insurer" in terms of "an insurer licensed to transact insurance in this State * * *." Thus, the nonadmitted surplus lines insurer is not an "insolvent insurer," within the meaning of the act, in the foreign State.

As respects the surplus lines insurer in its domiciliary State, section 3(a) of the Model Act stipulates that a claim is a "covered claim" only if the insurer became insolvent after the effective date of the act and "the claimant or insured is a resident of this State at the time of the insured event." It thus follows that the claim of the resident of the foreign State is not a "covered claim" of the guaranty association of the surplus lines insurer's State of domicile. This impresses us as an intolerable "catch-22" situation.

Interestingly, until 1973, the Model Act defined an "insolvent insurer" as "an insurer authorized to transact insurance in this State * * *," but even then, most States apparently construed "authorized" as being synonymous with "licensed."

Let me stress that we do not for a moment suggest that the bulk of surplus lines insurers are in shaky financial condition; indeed, many are the surplus lines running mates of large, financially sound insurers. On the other hand, we are uneasy that even a relatively few

seriously injured claimants may be deprived of all hope of compensation through the insolvency of a surplus lines insurer many of whose risks have no protection from any guaranty mechanism.

We continue to be concerned that the Federal chartering provisions of the bill may lead to dual regulation with all its potential overlapping, duplications of effort and expense, and jurisdictional conflicts. We have yet to be convinced that form approval, which the bill clearly leaves to the States, is so divorced from financial or rating concerns that divided responsibility is either feasible or desirable. For example, in the form approval statutes of many States there is a provision under which approval of an accident and health insurance form may be denied or withdrawn if the policy's benefits are found not to be reasonable in relation to the premiums. The question may well arise whether such a provision is a rate regulatory measure from which the federally chartered insurer is immune or whether it is a policy form matter within the clear jurisdiction of the State authority. We believe that myriad such matters need to be very carefully sorted out in the study of the bill which Senator Brooke has wisely counseled.

We believe that close attention must be accorded the issue of insurers opting in and out of the Federal system from time to time. In our view, competition between the State and Federal regulatory systems could be very beneficial to the insuring public if this were competition for excellence, as we would hope and expect it to be, but if the rival systems were ever to compete with each other in weakness or the ignoring of consumer interest, the result would be as disastrous for the insurance consumer as the reverse competition which is the curse and shame of consumer credit insurance.

We have made no secret of our uneasiness growing out of that phenomenon of the insurance institution known as selection-competition, or the ability of the insurer to enhance its competitive position and its profits by being more selective in its underwriting acceptances than its competitors. The instituting by some insurers of such a course of action creates a sort of competitive determinism requiring other insurers to do the same, as some of the insurance redlining studies have shown. We have often quoted former New York Superintendent of insurance Benjamin R. Schenck on the subject because of the aptness of his language. He said:

In insurance, however, there is one form of competition that seldom exists in the case of other products or services. That is selection competition—the ability of an insurer to affect its success, not by the price or quality of its products, but by selecting its customers in a fashion that will give it an advantage over its rivals. Selection competition is a feature of the insurance economy which seems to provide a ground for distinguishing insurance from other products and services and for fashioning for insurance a series of special rules unique to its problems and circumstances.

Selection competition should have few admirers. It is capable of totally denying to some people the opportunity to buy insurance at all in a day when many forms of insurance have become legal and practical necessities.

We would have no concern with the underlying theme of S. 1710 that the market is the better regulator if, but only if, the insurance consumer's right of selection is at least equal to that of the insurer. In short, we submit that a condition precedent to competitive rating must be the right and ability of every insurable consumer to select his

insurer and be written by that insurer on the same basis as every other risk falling within the same reasonable and objective risk classification. Only in such fashion can the advantages of competition be required to enure to the benefit of the insurance consumer.

As the committee surveys the entire spectrum of State-Federal insurance regulatory relationships, we venture the hope that the possibility may be explored of a mutually supportive and complementary relationship rather than one of rivalry or mutual exclusivity. There may be areas, for instance, of statistical and financial data gathering and compilation which are beyond the reach of individual State regulators in terms of resources or jurisdiction or both. State regulators might well welcome a Federal initiative in areas where there exists a need for data.

We close, as we began, with praise for the committee in making this hearing possible. It has offered a golden opportunity for a fresh look at present and prospective State and Federal roles in the regulation of insurance.

The CHAIRMAN. Thank you very much.

Mr. Sims.

STATEMENT OF JOE SIMS, DEPUTY ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION, DEPARTMENT OF JUSTICE, ACCOMPANIED BY GUY MASERITZ, CHIEF, LEGISLATIVE UNIT, ANTITRUST DIVISION

Mr. Sims. Thank you, Mr. Chairman.

With me today is Guy Maseritz, who's the Chief of the Legislative Unit of the Antitrust Division, and principal author of the Department of Justice report which I will refer to later on in my statement.

Pursuant to your invitation, I will significantly excerpt from my printed statement.

[Complete statement follows:]

STATEMENT OF JOE SIMS, DEPUTY ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION

Mr. Chairman and members of the committee: I welcome this opportunity to testify on S. 1710, the proposed "Federal Insurance Act of 1977." This bill would establish a federal system for the guarantee of insurance obligations and the formation of federally chartered companies to be regulated by a new independent federal agency, the Federal Insurance Commission.

S. 1710 appears to be designed principally to improve "the quality of regulation for solvency." On this issue, the Department must defer to those who are more knowledgeable on the problems of state solvency regulation. Our testimony today will deal solely with the narrower question raised by S. 1710—whether a dual system of insurance regulation would be an appropriate alternative to state rate regulation for fostering price competition and restricting federal antitrust immunity. As you know, the Department advanced such a proposal in its January, 1977 report on "The Pricing and Marketing of Insurance", as one possible approach to fostering competition in the insurance industry. I should emphasize that the Administration has not adopted a position on the issues raised by the report.

We are pleased that this Committee will be considering many of the difficult public policy issues raised by a legislative proposal designed, in part, to reconcile the public interest in a fully competitive system with the regulatory objective of a reliable insurance mechanism. I will outline today the findings of our limited study and what we see as the principal competitive issues raised by this legislation.

A. THE DEPARTMENT'S FINDINGS

In our study, initiated because of the existing antitrust exemption for the business of insurance, we sought to determine whether thirty years of state regulation has been adequate alternative to competition—i.e., whether state regulation (and antitrust immunity) has produced the benefits ordinarily expected from competition: reasonable prices based on the cost of rendering the services; efficient services rendered at the lowest possible cost; and innovation (the utilization of new or improved products or services and methods of distribution).

The Department's study focused principally on the pricing and marketing of property-liability insurance, particularly private passenger automobile insurance and commercial fire insurance. These two lines of insurance appear to raise most of the basic issues concerning the effects of rate deregulation and imposition of federal antitrust restraints on the business of insurance. We also briefly examined certain other lines of insurance raising special problems, such as "reverse competition," which I will discuss in greater detail later in this statement.

Over the past ten years, there have been a number of states that have adopted an "open competition" system of rate regulation after attempting to administer a highly regulated system. This experimentation with competitive controls is evidence of the inadequacies of state rate regulation. Moreover, the emergence of independent pricing in segments of the property-liability industry, despite restrictive state laws, may be attributed to an industry favorably structured for competition, to certain inherent weaknesses in rate regulation, to the successful experimentation with rate deregulation in a number of states, and to the continuing Congressional investigation into insurance industry practices.

Our studies of the effects of rigid rate regulation in automobile insurance indicate that such regulation has fostered greater adherence to bureau rates, discouraged rate reductions, contributed to instability in insurance company operations, established various forms of cross-subsidization between good and bad drivers, imposed unnecessary restrictions on the collective merchandising and the direct writing of insurance, and aggravated the availability problem, in which marginal or high risk drivers have difficulty obtaining coverage in the open (or "voluntary") market at the prevailing rates.

On the other hand, the long-run experience of at least one major insurance state under an open competition system, in which the state has relied on market forces to control prices, suggests that unrestricted price competition can provide a most effective substitute for rate regulation in obtaining the benefits normally expected from competition—reasonable prices and maximum efficiency in the sale and distribution of insurance.¹ A comparison of the experience of the same insurers under certain open competition and "prior approval" systems suggests that competition fosters independent pricing, operating stability, and flexibility in the pricing structure. The relatively favorable performance of the insurance companies themselves under the more competitive system suggests that it provides a more effective mechanism for accomplishing the basic insurance goals of a reliable insurance mechanism and generally available coverage at a price reasonably related to cost.

In the commercial lines, we found that state regulation is largely illusory and that insurers are generally free to set their own prices, largely because of the availability of state-authorized rating plans, which permit insurers to individually price risks based on their business judgment and competitive pressures. The prevalence of these plans—which generally supplant regulation—raises an obvious and fundamental question as to the continued need for state rate regulation in these lines of insurance.

Finally, we believe that the industry should be able to conduct its business without any special exemption from the federal antitrust laws. Antitrust precedent indicates that insurance companies could pool their loss experience through a statistical bureau consistent with federal antitrust standards. Moreover, we believe that the federal antitrust laws would not prohibit any necessary trending of future losses on a composite basis by advisory organizations that were

¹ See also New York Insurance Department Report on "The Open Rating Law and Property-Liability Insurance" (1977), at vi; and Illinois Insurance Department "Automobile Insurance Rate Study" (1977), at 6-9.

independent of the companies they were serving. Likewise, it appears that the antitrust laws would not prohibit those voluntary risk-sharing arrangements, such as insurance pools and reinsurance agreements, that were either necessary to the conduct of business or served some other legitimate business purpose without substantially lessening competition.

Based on these findings, the Report came to the tentative conclusion that an alternative scheme of regulation, without antitrust immunity, would be in the public interest. We suggested, as one possible approach, the formation of a dual regulatory system for insurance, using the federal banking system as a working model. Under such a system, insurance companies would have the option of seeking a federal charter and thereby losing McCarran Act protection, or retaining this protection under a state charter and remaining subject to the full scope of state regulation.

There are a number of provisions of the bill that are of particular importance from a competitive standpoint. These would: (1) establish a regulatory standard in favor of competition (§ 109(a)); (2) exempt federally chartered companies from state rate regulation (including regulation of risk classifications) except with respect to state residual market plans and lines of insurance raising problems of "reverse competition" (§ 204(a)(4)); (3) exempt federally chartered companies from state solvency regulation (§§ 204(a)(1) and (3)) and substitute a federal system of solvency regulation with emphasis on the early detection of failing companies (§ 107(b)); (4) prohibit invidious discrimination in the pricing, selection and classification of risks based, among other things, on race, age, and sex (§ 107(c)); and require as a condition of federal chartering that all insurers under common management or control be federally chartered.

B. THE COMPETITIVE ISSUES

There are several issues relating to solvency regulation, small insurers and agents, unfair discrimination, and "reverse competition"—that we believe should be considered by this Committee in evaluating the merits of S. 1710. The findings of our study of certain major lines of property-liability insurance suggest that these issues can and should be resolved in favor of greater pricing freedom and application of the federal antitrust laws. However, these issues involve the reconciliation of important competitive and social policy questions that have not been fully explored at either the state or federal level.

I will attempt to objectively outline these issues, although admittedly I do so from the perspective of an agency that favors greater reliance on competition as the market regulator.

1. Solvency regulation

The issue of appropriate solvency regulation involves three considerations. First, solvency regulation may be used by the states as an indirect means of regulating insurance rates. Thus, in life insurance apparently the so-called "expense limitation laws," together with minimum reserve standards, minimum and maximum surplus limitations, and dividend distribution requirements, serve as an alternative to rate regulation.¹ While these various forms of solvency regulation may be perfectly compatible with a fully competitive scheme, they must be administered in a manner consistent with competitive objectives.

Similarly, reliance on market controls to regulate prices appears to necessitate a new approach to solvency regulation as outlined by the New York Insurance Department in its 1974 report.² State insurance regulators (with exceptions) have traditionally sought to "keep every insurer afloat" rather than achieve early detection of failing companies and their swift removal from the marketplace if necessary.

Finally, it should be recognized that under a fully competitive system on a national scale, inefficient insurers may be forced out of the marketplace. To avoid severe disruptions, there might be mechanisms comparable to those administered by the FDIC, in the event that the regulatory controls fail to detect a financially unsound company in time to permit an orderly dissolution.

Certain provisions of S. 1710 partially address these concerns: Section 102 (establishing a federal guaranty fund on a preassessment basis), Section 107(b)

¹ Mayerson, "A New Look at the New York Expense Limitation Law," *Society of Actuaries Transactions*, Vol. VIII (1956), at 284.

² New York Insurance Department Report on "Regulation of Financial Condition of Insurance Companies" (1974), at 88, 89.

(establishing an "early warning system"), and Section 100 (establishing an explicit federal standard in favor of competition).

We also think it advisable as a general principle, under any system of federal regulation in which mergers and consolidations may be "facilitated," that the agency consult with the Attorney General, so that it can properly balance competitive considerations with other policy goals. Moreover, we would caution against undue emphasis on rehabilitation and reorganization, lest federal regulation interfere with the free market mechanism as a means of removing highly inefficient insurers from the marketplace.

2. Small insurers and agents

The Department's report did not examine in depth the potential impact of unrestricted price competition on smaller insurers. Nevertheless, we are not aware of any evidence that would suggest that efficient small insurance companies would be unfairly disadvantaged under a system of dual regulation.

There is no reason to assume that smaller insurers would be unable to compete in this environment. Indeed, small aggressive companies—seeking to expand their markets without the artificial restraints imposed by state licensing—may prefer federal chartering. Moreover, there is some suggestion that small insurers either possess or could develop independent underwriting and pricing skills. For example, in a federal antitrust framework, small insurers could have access to an independent advisory organization's trended loss cost data. Presumably, insurers specializing in certain risks—and thus exercising independent judgment in marketing and underwriting their services—would also have the ability to independently construct a rate structure, drawing on their own company's loss and expense experience and, to the extent relevant, the average experience of the bureau companies.

Moreover, we suspect that there are a number of "small" insurers that have the wherewithal to obtain outside professional advice when, in their business judgment, it is required. Independent actuarial and rate consultants can be retained by an insurer for the purpose of evaluating its own experience and the relevance of the industrywide experience. Other small insurers are part of an insurance company (or holding company) complex and may have access to professional advice from an affiliated company at a reasonable cost.

Finally, small insurers are also guided in their rate analysis by what their competitors are charging for comparable services and by the cost and availability of reinsurance, upon which small companies are particularly dependent in providing liability coverage, such as personal injury protection. We believe that competitors would be able to exchange certain price information within an antitrust framework, as outlined in our report (at pages 167-167).

In summary, we believe that the burden is upon the proponent to establish that efficient small insurers cannot operate in a fully competitive environment. Likewise, the favorable experience of smaller brokerage firms in a very competitive environment in the securities industry⁴ imposes a heavy burden upon insurance agents to establish that they would be unfairly disadvantaged under a fully competitive system. This complaint is often made, but rarely proven. It has certainly not been proven here.

3. Unfair discrimination

One of the more controversial issues raised by any proposal to substitute competitive controls for state rate regulation is the question of unfair discrimination in the sale of personal line property-liability insurance. The issue is raised both with respect to the so-called residual market, such as the state mandated automobile assigned risk plans, and the fixed commission rate structure.

The residual market issue is a complex one which we discuss at some length in our report (at pages 61-75). Essentially, the question is whether and how the mandatory plans can be regulated so as to interfere minimally with a competitively oriented voluntary market. For example, automobile insurers are generally required to participate in an assigned risk plan in proportion to their "voluntary" business in the state. If the rate charged drivers in the assigned risk plan is not self-supporting, then it must be subsidized by the voluntary market. A few state plans are operated on a self-supporting basis, but they represent the exception.

⁴ See, for example, the Fifth Report of the Securities and Exchange Commission to Congress on "The Effect of the Absence of Fixed Rates of Commissions" (May 1977), at 11.

In the past, such cross-subsidization has resulted in serious distortions in the marketplace, including discouraging insurers from increasing their market share of voluntary business. The substantial losses produced by the residual market plans, as well as a rigid rate structure in the voluntary market, have contributed to the availability problem.

We recommended in our report that federally chartered insurers be required to participate only in state residual market plans that are operating on a self-supporting basis. We suggested that "external" state subsidies might be a feasible solution to aiding lower income drivers by providing financial assistance (either through tax relief or direct payments) on the basis of need. There may be other solutions to this "affordability" problem, but we concur with the conclusion of the Stanford Research Institute that the "public and the industry would be well served by additional research into ways of implementing transfer payments that would interfere minimally with the free market forces."³

With respect to producers' commissions, there is some concern that in a deregulated system unwary and unsophisticated consumers will not be protected against unfair discrimination, particularly where agents are free to negotiate with individual buyers as to the level of commissions and insurers are able to collectively merchandise their insurance through group plans. We believe that certain state laws have unnecessarily discouraged insurers and agents from achieving maximum efficiency in the marketing of their services. There is some indication that fixed, ungraded commission rates, supported by state rating laws against unfair discrimination and rebating, have contributed to a regressive rate structure in automobile insurance, imposing the greatest burden on the lower income drivers.⁴

We believe that the process for determining the level of commissions—whether based on a fixed graded scale, rebating, or net pricing—should evolve from the interplay of market forces, subject only to appropriate disclosure requirements and antitrust constraints.

State restrictions on the marketing of automobile insurance (such as "fictitious group" laws) have not been the principal factors in impeding the growth of collective merchandising in the sale of automobile insurance. However, these artificial restraints appear to serve no legitimate regulatory objectives and may significantly deter future developments in the marketing of the personal lines of property-liability insurance under more favorable business conditions. We believe that insurers should be free to experiment with various forms of collective merchandising and direct writing, subject only to state regulations pertaining to the insurance contract, such as minimum coverage requirements, cancellation and renewal of policies, and policy forms.

4. Reverse competition

Section 204(a) of S. 1710 provides in part that a federally chartered insurer would not be exempt from state rate regulation in "any line of insurance (other than reinsurance) in which the Commission determines that the insurer competes principally for the producers' business rather than the business of the ultimate consumer." We understand that this provision is intended to deal with the problem of "reverse competition" which exists in title insurance and credit life and health insurance, and perhaps in life insurance generally. The problem essentially is that consumers are either "captive" buyers, uninformed buyers, or simply buyers indifferent to price variations among sellers. Consequently, insurers compete for the agents' business rather than directly for the business of the ultimate consumer, resulting in excessive commissions and prices.

In title insurance, the consumer is, in effect, captive because the service is ancillary to the principal transaction, which is the purchase of real estate. In credit health and life insurance, reverse competition stems from the inferior bargaining position or ignorance of the buyer who, again, may view the insurance service as ancillary to the principal transaction, which is the purchase of credit. I should point out, of course, that the antitrust laws as well as certain other provisions of law are designed to deter affirmative action by some

³ Stanford Research Institute, Final Report on "The Role of Risk Classifications in Property and Casualty Insurance..." (1976), at 4.

⁴ *Id.*, at 97; The New York Times, November 16, 1976, at T4. Rates are regressive in the sense that drivers who pay the highest premiums (and therefore the highest commissions) are generally those with lower incomes.

insurance sellers to "capture" consumers by tying insurance to, for example, credit. In life insurance, the dependence of the insurer on the agent to initiate buyer interest in the service and the lack of consumer knowledge may contribute to excessive commissions. At least this appears to be the rationale for the "expense limitation laws" which exist in only three states—New York, Illinois, and Wisconsin—but have broad impact because of their extraterritorial application.

The issue of reverse competition may require further study, particularly in life insurance, to determine the magnitude of the problem and the related question of need for state expense limitation laws, and the feasibility of permitting such problem lines to qualify for federal chartering but remain subject to selective forms of state rate regulation.

In summary, we have found a predominant segment of the property-liability insurance industry to be favorably structured for competition, with a large number of competitors, relatively moderate concentration, absence of significant economies of scale, a standardized service, a relatively simple and short-term contract, and an increasingly price-sensitive consumer market. The evidence currently available to us suggests that unrestricted price competition could be an effective alternative to state rate regulation and compatible with regulatory objectives for a reliable insurance mechanism.

The CHAIRMAN. Thank you, Mr. Sims, very much.

Your report concludes that an alternative scheme of insurance regulation without antitrust immunity would be in the public interest. You then suggest that a dual regulatory system as proposed in this bill, S. 1710, would be a good approach to that problem.

Why not just repeal the antitrust immunity for insurance companies in existing law? Wouldn't that create more competition among insurance companies and make pressures for more effective State regulation of insurance companies? As I understand it, what your proposal would do would be to repeal the antitrust exemption only for those firms that would opt to take a Federal charter.

Mr. SIMS. That's right.

The CHAIRMAN. The State regulated firms would still be exempt.

Mr. SIMS. That's right, they would still be exempt from the antitrust laws. That's a good question and I don't have a very precise answer to that. As we got more and more into the study of the insurance industry, what seemed to us at the beginning to be a relatively simple issue, that is, should we or should we not have antitrust exemption for insurance operations, became a much more complicated issue. I think the only thing that we are absolutely positive of as a result of our study is that the issue is a complicated one. Our proposal was an attempt to balance what we saw as a number of competing interests.

The CHAIRMAN. What do you see as the reasons for continuing the exemption? You say it's complicated. That was the one conclusion you could come to firmly.

Mr. SIMS. Well, I guess the basic reason that we did not propose just simple elimination of the immunity is that the insurance industry itself—or significant sectors of it at least—quite sincerely believe that they would not be able to undertake the kinds of ongoing operations which exist today without the existence of the exemption and that in the absence of being able to undertake those operations they could not perform the kinds of services that they perform today.

Our view, based on what we know of the industry, is that in most instances that probably is not correct, but we are not confident enough of that view across the board to come right out and say, "Remove the exemption."

We felt that the Federal chartering alternative provided a middle ground which offered significant portions of the advantages of removal of the exemption but still retained a certain regulatory mechanism in place.

Mr. MASERITZ. There's one thing I'd like to add.

The CHAIRMAN. You're the author of the study?

Mr. MASERITZ. Principal author.

The CHAIRMAN. Very good.

Mr. MASERITZ. There is one additional consideration and that is that when and if we had a proposal where the immunity was removed you would have a situation where existing antitrust exemptions with respect to State action would apply. Under the *Parker v. Brown* doctrine, where a State had a very active affirmative regulatory system—for example, Texas or Massachusetts, where the rates are actually made by the State—that kind of system would be immune and presumably provide insurers with immunity from Federal antitrust laws, whereas in a State like California which has perhaps the most progressive or one of the most progressive of the competitive systems but still maintains and permits the rate bureaus, those companies and bureaus would be subject to Federal antitrust restraints.

So, on the one hand, by lifting the immunity it would subject companies that are operating in a highly competitive system to Federal antitrust laws, whereas companies that were in a very highly regulated system would be completely immune with the possible result that you might discourage the States with competitive systems from maintaining their systems and encourage much greater affirmative regulation.

The CHAIRMAN. Take a situation like Texas or Massachusetts, where you say—I didn't understand this before—where you say that the State in effect determines the rates.

What kind of competitive situation do you have then if some of the big aggressive insurance firms opt to go under Federal charter, then wouldn't that create a pretty rough competitive situation? Wouldn't it be necessary for all of them to follow suit pretty much if they are going to compete? At least all in the same segment of the insurance industry.

Mr. MASERITZ. We think this would be one of the big inducements for companies to come into the Federal sphere, without antitrust exemption. That is, those remaining behind and wanting the protection of State regulation would be competing with those companies that elected to take the competitive route, and would be subject to vigorous competition on the basis of price in that State.

Mr. SIMS. Let me add one point if I may, that I think, unless we say it explicitly, sometimes gets lost in the discussion about a new system of Federal regulation.

Our firm conclusion was that the insurance industry required, in large segments of its operations, significantly less regulation than exists today. And we believe that a Federal chartering scheme of the kind we described in our report would in fact result in considerably more flexibility for companies to operate independently pursuant to competitive forces. The Federal regulatory chartering alternative in

our view is a lessening of regulation, and not a significant increase, because insurers will be induced by the competitive pressures of those who come into the Federal chartering scheme, to themselves enter the Federal scheme, thus removing them more and more from what in many instances has been in our view overregulation by the State.

The CHAIRMAN. I still don't understand the answer to the question, which was if you have the option in a State which has in effect a State-fixed rate, the option to come under Federal regulation, and escape from that, and of course the temptation under those circumstances then to cut your rates, so you can pick up a lot of business, wouldn't you have exactly that happen, and wouldn't you have a competitive situation which once a large competitor moved into that field, everybody would have to come in?

Mr. SIMS. I suspect in States where rate regulation was the strictest, you would have a considerable movement into the Federal chartering scheme, once any significant number of companies had moved into that scheme.

And in our view that is desirable, that would be highly desirable.

The CHAIRMAN. Clarify, if you can, for me the reason under those circumstances you would have them under the antitrust laws?

Mr. SIMS. Well, those companies which choose to obtain Federal charters would be able to compete within that State on the basis of the Federal regime, which in our proposal did not envision any rate regulation at all.

The CHAIRMAN. Is that the way the you read S. 1710 to do?

Mr. SIMS. For all practical purposes; yes.

The object of both our report and, as I understand it, S. 1710 would be to provide to federally chartered companies the opportunity to compete without rate regulation.

The CHAIRMAN. Mr. Hunter, section 101(f) of S. 1710 would transfer the HUD insurance programs which you administer flood insurance, crime insurance and so forth, to the new Federal Insurance Agency. These programs were set up to meet needs that were not being met by the regular insurance industry.

Do you think that these programs could be administered effectively by another agency, whose primary mission is to regulate and bolster the financial soundness of the conventional insurance industry?

Mr. HUNTER. First of all, Mr. Chairman, I believe that one agency can do more than one type of thing, of course.

The CHAIRMAN. Provided there is not a conflict.

Mr. HUNTER. Yes; there have been questions of conflict in this.

These are areas where there has been a breakdown in the private-State mechanisms, obviously, and they are unable to respond to at the State level. So I don't know that there is a conflict, because the basic breakdown exists whether or not the change in this legislation occurs, I believe.

That is already demonstrated by the fact that Congress did have to act on these. I believe they can be handled by the same agency.

The CHAIRMAN. Mr. Hunter, you also raised the question as to whether setting up this dual system would create a competition in laxity or competition in effective rigorous regulation.

Our experience is when you have this kind of situation, there is a strong tendency to make it one in laxity. After all, the people regulating are the people you see, they are the people you know, often the people who come out of that industry to do the regulation, and go back into it and be regulated.

Under those circumstances why do you think there is a case that you are going to strengthen rather than enfeeble regulation?

Mr. HUNTER. That was my question. I am not sure the answers are in on that. My belief is, among other things, part of the problem of State regulation is the fact of the boundaries, and the vertical splitting up of the regulatory function. I think slicing it horizontally into 100 pieces instead of 50 may end up with a lot more duplication, confusion and a lot more trouble. But that remains to be seen.

I have a very open mind on this. I don't believe the case has been made yet, as my statement indicates.

The CHAIRMAN. Well, there is one very important element here, which Senator Brooke has wisely put in his bill and Mr. Sims has properly stressed, and that is the fact that you would lose your exemption, and therefore you have to compete.

I think competition is often a far more efficient and effective regulator, especially of rates, than regulating by an agency.

My time is up, but do you want to comment? And please give us your name again, sir.

Mr. CLARK. I am Howard Clark.

The CHAIRMAN. Thank you.

Mr. CLARK. We do have some concerns, Mr. Chairman, because the insurance product is so vastly different from tangible products, such as refrigerators, or automobiles. And we are concerned that the competition in insurance may be selection competition, as we have indicated, because, you see, Mr. Chairman, this is an entirely different product.

The tailor who sells a suit of clothes knows exactly what his costs are before he sells those clothes. In insurance the cost of the product to the seller is determined only after the sale. In other words, the losses under the policies will determine what the ultimate cost of the product to the seller is.

Now if this be true, then obviously the seller, by selecting very carefully the persons to whom he will sell that product, can affect its ultimate cost and therefore you have the appearance of the residual market, the people who fall through the cracks.

I think the FTC, in the study it did for the DOT automobile study, put the matter of assigned risk plans, the FAIR plans, the residual markets, very excellently when it said:

The hard to place problem is an integral part of the competitive functions of the automobile insurance industry. It is a by-product of underwriting competition. Despite a complex objective rating scheme, insurers do not find it profitable to grant coverage to all applicants. Even within the most highly developed rating classification, there are still some drivers who have distinctly higher than average loss potential. Insofar as the rating system fails to account for these differences, there is an opportunity for insurers to increase their profits through selective underwriting.

This is the concern we have. We are not so far apart from Justice as to the desirability of competition.

The CHAIRMAN. You mean the Department of Justice, you are right in line with justice?

Mr. CLARK. We treat them as synonymous, Mr. Chairman. We say that the predicate for competition must be the ability of the insurer, the reasonably insurable insured to select the insurer of his choice.

We became terribly concerned, Mr. Chairman—we have mentioned Texas, where rates are promulgated by the Texas board. But under a sort of quirk in the Texas law, there are 26 county mutuals that are subject to no rate regulation. We would invite this committee to inquire as to why.

For example, there is a Kemper County Mutual, a State Farm County Mutual, there is an INA County Mutual, a Foremost County Mutual. A number of these county mutuals are subject to no rate regulation at all.

The last time I looked at the situation, Mr. Chairman, all of those county mutual insurers wrote at a considerably higher rate than the rates promulgated by the Texas board.

I think that is a facet of the matter that is deserving of close attention.

The CHAIRMAN. Thank you very much. That is an excellent clarification. Senator Brooke.

Senator BROOKE. Except, as you know, we leave the assigned risk still with the State, there is no problem there, we have taken care of that.

Thank you, Mr. Hunter, I will start with you first, and then Mr. Sims.

Mr. Hunter, would it be fair from your statement to conclude the following: First, the administration does recognize that the present system of State guarantee funds has serious weaknesses?

Mr. HUNTER. The Federal Insurance Administration does, sir.

Senator BROOKE. You are the administration for that purpose?

Mr. HUNTER. Yes; I believe that is true. There are weaknesses that you quite accurately spelled out in your opening statement, sir.

Senator BROOKE. Second, you are not ready yet to suggest an alternative to the present guarantee system?

Mr. HUNTER. We have——

Senator BROOKE. The administration is not yet ready to make such a recommendation?

Mr. HUNTER. I don't believe we are ready to make a final suggestion. We think these hearings would clarify the situation here and downtown.

Senator BROOKE. Third, the administration is neither endorsing or opposing the concept embodied in S. 1710, although you do have some concerns, as you indicated, about some sections of this bill?

Mr. HUNTER. I think our concerns were more on the dual chartering than the solvency, as my statement reads, sir.

Senator BROOKE. Are there any studies underway in the administration on the subject of insurance regulation for solvency purposes?

Mr. HUNTER. I don't know of any at this time.

Senator BROOKE. Is any such study being contemplated?

Mr. HUNTER. We have a study being contemplated that would get at it tangentially, but not a direct study.

Senator BROOKE. What study is that?

Mr. HUNTER. We have a study on the social—it is out for bids currently—on the social policy questions of insurance regulation.

Senator BROOKE. But that does not address itself to solvency?

Mr. HUNTER. No. It is broader, but presumably we will get at that somewhat by the nature of it.

Senator BROOKE. You say it is out for bids already?

Mr. HUNTER. That is correct.

Senator BROOKE. Would you supply for the record the exact nature of that study?

Mr. HUNTER. Yes, I will.

[The Department submitted the following information:]



DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410

OFFICE OF THE ASSISTANT SECRETARY
FOR ADMINISTRATION

AUG 15 1977

IN REPLY REFER TO:
ACS-N

REQUEST FOR PROPOSAL NO. H-4601

Gentlemen:

This is a Request for Proposal to perform a Study of Insurance and Public Policy.

You are invited to submit a proposal to be received not later than 2:00 p.m. local time at the place designated for receipt of offers, August 26, 1977, to the Department of Housing and Urban Development, in accordance with this Request for Proposal and the following attachments which are incorporated herein and made a part hereof:

- Attachment A - Contract Schedule (Includes Statement Of Work and Factors For Award)
- Attachment B - Proposal Instructions and Conditions
- Attachment C - General Provisions, HUD-736,
- Attachment D - Additional General Provisions, HUD-736.1 and HUD-736.2
- Attachment E - Contract Pricing Proposal, Optional Form 60
- Attachment F - Certifications and Representations
- Attachment G - Clean Air and Water Certification
- Attachment H - Clean Air and Water Clause
- Attachment I - Disclosure Statement-Cost Accounting Practices and Certification
- Attachment J - Employment of The Handicapped
- Attachment K - Certification of Status As A Minority Business Enterprise
- Attachment L - Privacy Act Notification and Privacy Act
- Attachment M - Disabled Veterans and Veterans of The Vietnam Era

Attachment N - Certificate of Current Cost & Pricing
A firm fixed price contract is anticipated to be awarded as a result of this RFP. However, HUD reserves the right to award the type of contract most appropriate after negotiations and to substitute provisions of this RFP as necessary. Therefore

you are requested to submit a proposal on a basis which is considered to be realistic for the approach you proposed.

Contracts will be awarded to the responsible offerers whose proposals are within the competitive range and determined to be the most advantageous to the Government, price and other factors considered. The factors to be considered in the evaluation of the proposals and selection of the Contractors are set forth in Attachment B.

Inquiries regarding this Request for Proposal should be directed to Alicann Nolte, (202) 724-0038.

Mailed proposals must be mailed to the following address:

Department of Housing & Urban Development
Office of Procurement and Contracts
Room B-133 (711 Building)
451 Seventh Street, Southwest
Washington, D. C. 20410

HAND DELIVERIES MUST BE MADE TO:

711 14th Street, N. W.
Room 912
Washington, D. C.

To assure that the proposal arrives at the proper place on time and to prevent opening by unauthorized individuals, your proposal must be identified on the envelope or wrapper as follows:

Proposal Submitted In Response to RFP H-4601
Due Date: August 26, 1977, 2:00 p.m. Local Time At
The Place Designated For Receipt of Offers.

LATE PROPOSAL WARNING: The conditions applicable to late proposals in Paragraph 10, Attachment C, will be strictly applied.

Sincerely,

Vito Vollero
Vito Vollero
Contracting Officer

Attachments

This RFP consists of 59 pages

SCHEDULEINDEX OF ARTICLES

- ARTICLE I - SCOPE OF WORK
- ARTICLE II - CONDUCT OF WORK
- ARTICLE III - INSPECTION AND ACCEPTANCE
- ARTICLE IV - REPRODUCTION OF REPORTS
- ARTICLE V - COORDINATION OF FEDERAL REPORTING SERVICES
- ARTICLE VI - CONTRACT PERIOD
- ARTICLE VII - PRICE, PAYMENT AND SUBMISSION OF INVOICES
- ARTICLE VIII - AVAILABILITY OF FUNDS

SCHEDULEARTICLE I - SCOPE OF WORK

The Contractor shall furnish the necessary personnel, materials, services, equipment, facilities (except as otherwise specified herein) and otherwise do all things necessary for or incident to the performance of the work set forth in Exhibit A, attached hereto and hereby made a part hereof.

ARTICLE II - CONDUCT OF WORK

- A. The Government Technical Representative (GTR) for liaison with the Contractor as to the conduct of work is _____
or a successor designated in writing by the Contracting Officer.
- B. The GTR may issue written or oral instructions to fill in details in the Statement of Work described in this contract. Such instructions must be within the scope of the work set forth in this contract and may not be of such a nature as to affect price, period of performance or any other provisions of this contract.
- C. The Contractor's work hereunder shall be carried out under the supervision of _____.

See Exhibit A for Schedule of Key Personnel provided as required under Clause 23 of the General Provisions.

ARTICLE III - INSPECTION AND ACCEPTANCE

Final inspection, pursuant to the Clause entitled, "INSPECTION" of the General Provisions, and acceptance of all work required under this contract shall be performed by the GTR.

ARTICLE IV - REPRODUCTION OF REPORTS

Reproduction of reports, data or other written material, if required herein is authorized provided that the material produced does not exceed 5,000 production units of any page and that items consisting of multiple pages do not exceed 25 000 production units in aggregate. The aggregate number of production units is to be determined by multiplying pages times copies. A production unit is one sheet size 8 by 10 1/2 inches or less printed on one side only and in one color. All copy preparation to produce camera ready copy for reproduction must be set by methods other than hot metal typesetting. The reports should be produced by methods employing stencils, masters and plates which are to be used on single unit duplicating equipment no larger than 11 by 17 inches with a maximum image of 10 3/4 by 14 1/4 inches and are prepared by methods or devices that do not utilize reusable contact negatives and/or positives prepared with a camera requiring a darkroom. All reproducible (camera ready copies for reproduction by photo offset methods) shall become the property of the Government and shall be delivered to the Government with the report, data or other written material.

SCHEDULE CONTINUEDARTICLE V - COORDINATION OF FEDERAL REPORTING SERVICES

In the event that it is a contractual requirement to collect information from ten or more public respondents, the provisions of 44 U.S.C. Chapter 35 shall apply to this contract and the Contractor shall obtain through the Government Technical Representative (GTR) the required Office of Management and Budget clearance before making public contacts for the collection of data or expending any funds. The authority to proceed with the collection of data from public respondents and expend funds shall be in writing signed by the Contracting Officer.

ARTICLE VI - CONTRACT PERIOD

The Contractor shall complete all work hereunder, including delivery of the final report on or before eighteen (18) months after the effective date of this contract.

ARTICLE VII - PRICE, PAYMENT AND SUBMISSION OF INVOICES

- A. The Government shall pay the Contractor as full compensation for all work required, performed and accepted under this contract, inclusive of all cost and expenses, a total firm fixed price of \$_____.
- B. The Contractor shall submit an original and five (5) copies of each invoice or public voucher identified by the Contract Number to the Contract Administrator.

ARTICLE VIII - AVAILABILITY OF FUNDS

Funds are not presently available for the described services. Any contract awarded as a result of this solicitation is contingent upon availability of appropriated funds from which payment for services under the contract can be made. No legal obligation on the part of the Government for payment of any money under the contract shall arise unless and until funds are made available by the Contracting Officer for this contract and a notice of such availability to be confirmed in writing by the Contracting Officer is given to the Contractor.

A STUDY OF INSURANCE AND PUBLIC POLICY

Statement of WorkI Background

At Section 1102 of the Urban Property Protection and Reinsurance Act of 1968 (82 Stat 556.12 USC 1749), the Congress found that the "vitality of many American cities is being threatened by the deterioration of their inner city areas; responsible owners of well maintained residential, business, and other properties in many of these areas are unable to obtain adequate property insurance coverage against fire, crime, and other perils, the lack of such insurance coverage accelerates the deterioration of these areas by discouraging private investment and restricting the availability of credit to repair and improve property therein; and this deterioration poses a serious threat to the national economy."

In order to ameliorate these conditions the Congress provided for a program of reinsurance against property losses resulting from riots or civil disorders for insurers or pools of insurers participating in State FAIR plans (Statewide plans to assure fair access to insurance requirements). The program was assigned to the Secretary of Housing and Urban Development who in turn delegated its administration to the Federal Insurance Administrator, a position created by Section 1105 of the Act.

Subsequent amendments added a program of Federal insurance against burglary and theft, the Federal Crime Insurance Program, and an Office of Review and Compliance charged with reviewing the operations of the State FAIR plans to assure that they are effectively making essential property insurance readily available in the Nation's communities.

Section 1246 of the Act authorized the Secretary to undertake studies on the operation of FAIR Plans, the extent to which essential property insurance is unavailable in urban areas, the market for private reinsurance, loss prevention methods and procedures, insurance marketing methods and underwriting techniques. By delegation of the Secretary the responsibility for conducting or contracting for these studies falls on the Federal Insurance Administrator.

Pursuant to his special responsibility for the residual market and special concern for the availability of essential insurance to the Nation's citizens, the Federal Insurance Administrator undertook a study of residual insurance markets in 1972 which culminated in his report, Full Insurance Availability, in September 1974.

That report recommended a program of full insurance availability under which all consumers who are insurable on the basis of objective criteria would be assured access to all of the coverages offered by the private insurance market and any consumer could apply to any insurance company through its regular insurance channels and would be assured of the same coverage, rates and services as any other insured of that company occupying the same risk classification. The report outlined how the plan would work and how it would affect insureds, agents, brokers and insurers.

The report found that the States had not sufficiently addressed the problem of the denial of insurance through the voluntary market to large numbers of applicants and the relegation of hundreds of thousands of loss-free risks to the FAIR plans and other risk mechanisms.

It found that the current multiplicity of automobile insurance classifications is not based on statistical evidence, nor is the experience produced by such fragmentation credible, resulting in a violation of the fundamental principle of spread of risk inasmuch as the resulting smaller class sizes make it impossible for many individual classes to be self sufficient, either statistically or fiscally. The excessively refined class plan becomes a device for selectivity which is used to thwart statutory prohibitions against cancellations and refusals to review; in effect, such class plans make it possible for insurers to "rate out" risks which they cannot "write out" of their portfolios. Furthermore, it found under this system of extreme selection, millions of careful, safe and honest FAIR Plan and assigned risk plan insureds are paying substantially higher premiums than necessary and are actually subsidizing the owners of abandoned properties, the irresponsible, the drunk and the reckless driver.

The report also found that the concern of the public regarding the availability of insurance is manifested by the periodic introduction of legislation in the Congress to provide either Federal control or direct Federal insurance where insurance is unavailable or available at rates in excess of what are deemed "affordable".

In recommending a system of Full Insurance Availability, the report proposed that all consumers who are insurable should be able to apply to any insurance company providing the desired coverage through regular insurance channels and should be assured of the same treatment as any other risk of that insurer in the same class. The insurers would be authorized to cede to a Statewide Reinsurance Exchange all or portions of the risks they did not choose to retain fully for their own account. The insurance industry would be required to utilize objective and statistically supported classifications of risk and to compile credible statistical data consistent with basic principles of insurance. State insurance departments should establish uniform statistical plans to assure that experience would be collected in a meaningful and intelligible way. The plan calls for all companies licensed to do business in the State in the lines of insurance covered by the Full Insurance Availability system to be required to participate in the financial results of the Exchange.

The report noted that consumers of insurance lack basic information concerning coverage and rates, that if competition is to be effective, so that insurers with superior product and price can prevail, the public must have information available upon which to make intelligent decisions. It recommended that the State insurance authorities establish public information centers to meet this need.

The report concludes that only with Full Insurance Availability, the recommended reforms in classification, the provision of the required statistics and the availability of information to the consuming public, could "open competition", as practiced in a number of states, be justified and be appropriate.

Ironically, competition through risk selection rather than through price, service, product quality and sales promotion creates a vicious circle which requires insurers to be increasingly selective regardless of their own wishes and the long term best interests of the industry thus aggravating market distortion and reducing service to insurance consumers.

Implicit in the discussion of Full Insurance
Availability above is the realization that insurance, once regarded as an optional luxury, has now become a social, business and personal necessity.

Paradoxically, the increased necessity of insurance and the decreased need to promote and sell has not created a utopian market for the industry; instead it has spawned an increasing number of challenges and problems for the insurance industry.

Inflation, the influence of fluctuations in securities prices on insurance surplus and therefore on capacity, large jury awards, the increased tendency to file lawsuits, over-cautious underwriting, the explosive effect of consumerism and environmental concerns on the perception of insurance requirements, the increasing difficulty of securing insurance through regular channels for urban property, all of these have been reflected in problems of unavailability of essential insurance.

In this same environment the nation faces extremely critical problems in medical malpractice, workers compensation, products liability, municipal liability and related lines. Many are prone to seek Federal solutions to such problems. Similarly some proposals for National Health Insurance would exclude the insurance industry from a significant role.

Questions have been raised about the effectiveness of competition in the insurance industry in protecting consumers. Questions have also been raised about the effectiveness of state regulation in both the protection of consumers and the assurance of the solvency of insurers. The role of the insurance industry is bound to be a significant factor in the developing inquiries in the search for alternative methods of injury reparation.

All of these developments involve questions of public policy, of economic efficiency and of the preservation of an effective role for the private enterprise insurance industry. These questions call for investigation, for analysis, for illumination and for interpretation.

Some research has been done on major insurance problems. One company has done some fine work in modeling natural disaster exposure. Another has made significant efforts in the area of automobile accident loss reduction. A few have studied insurance markets. But little has been done in the major areas of public policy and insurance.

The Federal Insurance Administrator proposes an objective study of these problems which will encompass, as it develops, the statistical method in property insurance, incentive and moral hazard, intra-industry subsidy mechanisms, the economic role of insurance, the efficiency of insurance markets, ways in which state regulation can contribute to greater market efficiency and roles for the private insurance industry in meeting the critical insurance needs of the public.

The emphasis will be on illuminating public policy with the goals of consumer protection and economic efficiency. Only by achieving full information and understanding of these issues can the Federal Insurance Administrator be in a position to respond to the inevitable Congressional inquiries and initiatives in a manner which serves the public interest, the protection of consumers, and the strengthening of state regulation, with due recognition to the essential role of the private enterprise insurance industry in providing the insurance services which our nation requires.

This RFP is designed to perform the essential preliminaries for such a study. It is related to the fact that the property and liability insurance industry suffers from insufficient basic research. Such research in turn is hindered by significant data limitations.

II Objective

The objective of this study is to develop a solid foundation for analysis by overcoming, to the greatest extent possible, the data limitations and outlining the path and direction of the successive inquiries. Specifically the purpose of this study is to develop a literature search for relevant topics in property casualty insurance to classify and abstract such literature, to review data sources for statistical and insurance information in this area, on the basis of the literature and data source review and classification to develop an Insurance Policy Resource Book, to define critical issues in this area of insurance requiring study and to perform a critical evaluation of existing literature on Insurance Classification, preparing a final report encompassing the results of the research.

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III Scope of Work

In order to achieve the above stated objective, the contractor shall provide the necessary personnel, clerical services, materials, equipment and facilities to accomplish the following tasks:

Task A

The contractor shall submit within thirty (30) days after the award of the contract a work program including rationale, criteria, procedures and framework for analysis for the tasks below. The GTR will provide review comments on the work program to the contractor within thirty (30) days. The work plan must be approved in writing by the GTR prior to initiation of the following tasks.

Task B Literature Search

The contractor shall review current and recent literature on property and casualty insurance. In so doing he shall give special, but not exclusive attention to the following:

1. Availability of Insurance
2. Affordability of Insurance
3. Fire Insurance
4. Crime Insurance
5. Automobile Insurance
6. Other Liability and Casualty Insurance
7. Classification and Pricing of Insurance
8. Non-standard and Surplus Lines Insurance
9. Assigned Risk Plans
10. Profitability and Growth of Residual Market Insurers
11. Statewide Reinsurance Facilities
12. Joint Underwriting Associations
13. No Fault Insurance
14. Product and Professional Liability
15. Actuarial Practice in Property/Liability Insurance
16. Underwriting Practice in Property/Liability Insurance
17. Workers Compensation Systems
18. Effective Competition
19. Open Competition
20. State Regulation of Insurance

Task C Classification and Abstracting of Sources

1. Upon the basis of the literature review and consultation with appropriate knowledgeable individuals and organizations, the contractor shall divide the articles, books, pamphlets and other materials into those which are relevant and those which are irrelevant. The relevant sources shall then be classified as follows:

- a. Abstract for certain
- b. Abstract if possible
- c. Abstract perhaps
- d. List but do not abstract

2. Prepare 100 abstracts of 150 - 200 words each of those falling in categories a and b above. Such abstracts shall identify the subject discussed, the hypotheses tested, etc., summarize the major components of research, list and comment briefly on the results.

3. Prepare at least 50 abstracts of 30 - 35 words each of sources in categories a, b and c above exclusive of those abstracted in C - 2 above.

4. For all articles and sources in categories a, b, c and d prepare an index showing in addition to author, title, publisher or publication, volume and date, appropriate categories which may include: (1) types of insurance covered or referred to; (2) nature of article; empirical, theoretical, or commentary (3) degree of evaluation and classification by subject.

Task D Statistical and Insurance Data

The contractor shall survey the availability of statistical data on insurance finances, underwriting, profits, losses, classifications, sales, income and other measures of insurance activity for fire, crime, automobile and liability insurance. This survey shall include published data, data available from insurance companies, insurance associations, insurance rating bureaus, reinsurance facilities, state regulatory authorities, Federal agencies and insurance and financial reporting agencies, data available at no cost and data retrievable at reasonable cost.

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For these data sources information shall be gathered about the availability of data for the following:

- Type of insurance (e.g., fire, crime, or auto)
- Geographical detail (e.g., national, regional, state, metropolitan area, or by county)
- Type of reporting unit (e.g., individual policyholder; individual claim; company; or groups of companies)
- Collection method (e.g., closed claim survey; personal interviews; mail questionnaire; data regularly collected under standard statistical plans of rate bureaus; etc.)
- Period covered by available data
- Coverage (e.g., universe or sample with response rates)
- Access status (e.g., printed, card, tape)
- Contact for data (e.g., name, title, company or agency, address, telephone number)
- Access arrangements (e.g., time required, cost)

In addition the contractor shall survey all statistics, particularly time series, relevant to analysis of the insurance industry and non-insurance data relevant to insurance classification such as demographic data, accident statistics, police reports and the like.

On the basis of his examination of these sources of information necessary or useful in the analysis of insurance problems, the Contractor shall index them in a system compatible with that used in Task C above.

Task E Develop Insurance Policy Source Book

On the basis of the listings, abstracts, classification and indexing of publications and data sources performed on Tasks C and D above, the Contractor shall develop a policy source book for studies in insurance and public policy. In so doing the Contractor shall...

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1. Edit the abstracts prepared in Task C above,
2. Incorporate classified lists of articles, books and reports relative to public policy on insurance as prepared in Task C above,
3. Give special attention to materials on the availability and affordability of insurance,
4. Incorporate the data sources developed and classified in Task D above,
5. Include articles and or abstracts on the concept of effective competition, state regulation, product and professional liability, insurance underwriting income and loss, investment income, insurance capacity, insurance ratemaking, residual markets and the Federal role in insurance,
6. Organize the Insurance Policy Source Book so that it will be a valuable resource, data base and reference source for researchers and policymakers in the areas of public policy in insurance, Federal role in insurance residual markets, classification and statistical method, incentive and moral hazard, subsidy mechanism, economic impacts, market performance and related areas.

Task F Define Critical Issues

Upon the basis of his literature review the contractor shall define areas within the broad field of insurance and public policy requiring research and investigation.

1. In examining areas of research, consideration shall be given to, but not limited to, such subjects as,
 - a) Availability of essential property or casualty insurance,
 - b) Affordability of essential property or casualty insurance,
 - c) Residual market mechanisms

- d) Actuarial predictability
- e) Capacity and insurance availability,
- f) Injury reparation and insurance availability,
- g) Classification and statistical method,
- h) Ratemaking and statistical method,
- i) Incentive and moral hazard,
- j) Internalization and subsidy mechanisms
- k) Financial power and capacity as insurance market factors,
- l) Efficiency of competition and market organization,
- m) Ways in which the insurance industry can perform an effective role in the solution of current and evolving insurance problems of public and national concern.
- n) Possibilities for more effective contribution by State regulatory authorities to the solution of insurance problems of public concern.
- o) Insurance and inflation

2. From the issues of critical concern considered, the Contractor shall select those for which he recommends that research be undertaken and for which he is satisfied that data can be secured and analytical methodology is available. For those issues selected, the Contractor shall...

- a) Arrange them in order of priority, assigning equal priority, if necessary, to those that could be undertaken simultaneously.
- b) Provide the following information:
 - 1) Title of the issue
 - 2) Description of the issue
 - 3) Why the issue is important

**Task G Introductory Investigation of Risk
Classification in Property and Casualty Insurance**

On the basis of his review of the literature and experience in examining property and casualty insurance classifications, the bases for the classifications, the inferences and assumptions on which the classifications are based, the implications and impacts of such classification, the contractor shall prepare a critical review of the literature with implications for further investigation.

IV Task Products

A Monthly Progress Reports

The contractor shall submit five (5) copies of a monthly Progress Report covering work accomplished during each calendar month of contract performance for each task. The reports shall be brief and factual, and shall include:

- a. Appropriate cover information
- b. A description of overall progress plus a separate description of progress for each task on which effort was expended during the report period. Description shall include pertinent data and sufficient detail to explain significant results achieved.
- c. A description of current problems and proposed corrective action in terms of impact on cost, manpower and timeliness of performance.
- d. A description of the work to be performed during the next reporting period.
- e. An explanation of any significant deviation between planned and actual expenditures, manpower and schedules.

The monthly Progress Reports shall be submitted to the GTR not later than the tenth (10) working day after the reporting period.

B Work Plans

The contractor shall submit to the GTR, within thirty (30) workdays after contract award, five copies of a work plan, identified in Task A above.

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C Interim Reports

The contractor shall submit to the GTR for comment five (5) copies of the draft interim reports of:

- Task B - Literature Search
- Task C - Classification and Abstracting
- Task D - Statistical and Insurance Data
- Task E - Insurance Policy Source Book
- Task F - Critical Insurance Issues Requiring Study
- Task G - Critical Evaluation of Existing Literature
on Insurance Classification

D Draft Final Report

The Draft Final Report, encompassing the products of Tasks B through G shall be submitted in three (3) copies to the GTR for his review and comments no later than 15 months after the signing of the contract.

The GTR will return his comments within thirty (30) days after receipt of the draft final report.

E Final Report

The Final Report called for under Task H of this contract shall be submitted to the GTR no later than eighteen (18) months after award of the contract, in 15 copies, one of which shall be an error free reproducible copy.

F Report covers

Report covers shall be written in the following form:

(1) Interim Reports

Interim Report
on
(subject)
Task _____
of
A Study of Insurance and Public Policy
by
Contractor

Performed under Contract No. _____ for the Federal Insurance
Administration, U. S. Department of Housing and Urban Development

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(2) Draft Final Report

A Study of Insurance and Public Policy
by
Contractor

Date .

Performed under Contract No. _____ for the Federal Insurance
Administration, U. S. Department of Housing and Urban Development

(3) Final Report

A Study of Insurance and Public Policy
by
Contractor

Date

Performed under Contract No. _____ for the Federal Insurance
Administration, U. S. Department of Housing and Urban Development

14.

V Schedule

The above products shall be delivered in accordance with the following schedule:

<u>Product</u>	<u>Delivery Date</u>
Task B	4 months after contract award
Task C	6 months after contract award
Task D	9 months after contract award
Task E	11 months after contract award
Task F	1 year after contract award
Task G	13 months after contract award
Draft Final Report	15 months after contract award
Final Report	18 months after contract award

Factors For AwardPart I - Technical and Management Factors

Technical and management factors which will be used in the evaluation of proposals are set forth below, with subfactors being of equal importance.

A Understanding and Approach (35)

Understanding of project objectives, scope and task; quality and effectiveness of conceptual and technical approach, with special emphasis on public policy consideration; grasp of potential research difficulties and suggested methods for their solution; extent to which alternative approaches to the research have been considered and the rationale for selection of the proposed approach.

15.

B Competence of Key Personnel (35)

1. Project Manager - Experience in managing projects of similar scope and complexity; experience in research for public policy determination; proper ability to manage performance of required tasks within time and resource limits; time commitment to management of this project; relevant experience and capability in directing projects or programs involving most of the following areas:

- a) Insurance - including risk classification, rate-making, underwriting, availability of insurance
- b) Economic analysis - including studies of competition and market performance, price structure, market segmentation, industrial organization, economics of insurance, economics of finance, risk and uncertainty, regulation of industry, public policy
- c) Statistical analysis - including, probability theory, correlation and regression analysis, analysis of inference, significance, statistical methods in risk analysis
- d) Actuarial analysis - risk measurement and rate making in property and casualty insurance
- e) Public policy - consideration of meeting social and public requirements from scarce resources.
- f) Data collection - including the ability to earn the confidence and cooperation of industry sources

2. Key Professionals - Adequacy of professional competence, skills and experience to carry out effectively, under direction, the task responsibilities in the project - Extent of involvement in specific tasks.

16.

C Organizational Qualifications (15)

Experience of the organization and its component elements, associates or sub-contractors, in pursuing successful research efforts in similar or closely related areas, with special emphasis on public policy considerations and in coordinating and effectively utilizing staff with expertise in

- a) Insurance
- b) Economic analysis
- c) Statistical analysis
- d) Actuarial analysis
- e) Public policy formulation

The organization should demonstrate its qualification on the basis of its experience, that of its principals, its professional staff, and of the professionals associated with it for this effort, to produce a report of a quality to be useful and credible in public policy formulation.

D Project Organization and Management Plan (15)

1. Soundness and completeness of the organization and management plan of the proposers for the project in terms of

definition of responsibility and accountability for specific tasks and functions of specific named key individuals within the organization and their specific time commitments:

2. Work program of task, subtask, products and time schedule for the performance of these tasks and delivery of reports; and procedures for supervising, coordinating and evaluating task performance and for maintaining financial and time schedule control

Emphasis which organization management would place on this effort, specifically its ability to commit capable staff to support the project and assure completion on schedule.

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Part II - Cost Factors

If the award is made on the basis of the initial proposal submitted, in response to this request for proposals, the Proposal costs will be considered in addition to the factors described in Part I above to determine which proposal is most advantageous to the Government.

If award is made after establishment of a competitive range and negotiations are entered into with the proposers in the competitive range, the final cost submitted will be considered in addition to the factors stated in Part I above, to determine which proposal is most advantageous to the Government.

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
PROPOSAL INSTRUCTIONS AND CONDITIONS

1. LIMITATION

This Request for Proposal does not commit the Government to award a contract, to pay any costs incurred in the preparation of a proposal to this request, or to procure or contract for services or supplies. The Government reserves the right to accept or reject any or all proposals received as a result of this request, to negotiate with all qualified sources, or to cancel in part or in its entirety, this Request for Proposal, if it is in the best interest of the Government to do so. The Contracting Officer may require the offeror selected to participate in negotiations, and to submit such price, technical, or other revisions of their proposals as may result from negotiations.

2. FORMAT

Proposals should not be submitted in an elaborate format and expensive binders. Legibility, clarity and completeness are important and essential.

3. PROPOSAL SUBMISSION

Proposals shall be submitted in two separate parts as further described in (a) below and shall be enclosed in a sealed envelope and addressed to the office specified in the solicitation. The proposal shall show the hour and date specified in the solicitation for receipt, the solicitation number, and the name and address of the offeror, on the face of the envelope.

It is very important that the proposal be properly identified on the face of the envelope as set forth above in order to insure that the date and time of receipt is stamped on the face of the proposal envelope since the Departmental mailroom receiving procedures are: (a) date and time stamp those envelopes identified as proposals and deliver them immediately to the appropriate procuring activity, and (b) only date stamp those envelopes which do not contain identification of the contents and deliver them to the appropriate procuring activity through the routine mail delivery procedures. If the above is followed, proper consideration can be given to that proposal in accordance with paragraph 10(e)(2) below, as may be appropriate.

(a) Part I shall consist of the technical and management submittal of the proposed work. Part II shall consist of complete cost and pricing data, which shall include the Attachment entitled "Cost and Pricing Data", completed by the offeror, and any addenda thereto. Each part of the proposal shall be complete in itself in order that the evaluation of both parts can be accomplished concurrently, and the evaluation of the technical and management submittal can be made strictly on the basis of its merit.

(b) Proposals shall be submitted in six (6) copies each of Part I and five (5) copies each of Part II.

(c) Telegraphic proposals will not be considered unless authorized by the solicitation; however, proposals may be modified by telegraphic notice, provided such notice is received prior to the time set forth in paragraph 10 of this Proposal Instructions and Conditions.

Replace Previous Edition and Form HUD-770.1, which are Obsolete

4. PROPOSAL CONTENT AND OUTLINE

(a) Part I - Technical and Management

Section 1: Proposal Coverage. Cover the scope of work and general objectives to which the proposal is addressed.

Section 2: Tasks and Methods. Describe the principal tasks or sub-projects to be undertaken together with a discussion of their relationships to each other. Discuss the considerations for selecting, performing and the time sequencing of the tasks or sub-projects. Describe and discuss the method of personnel training and field personnel recruitment and the method of project control to be applied to the project to ensure timely, professional and quality performance. The Contractor must clearly state his plan for project management and in providing current and updated project progress to HUD during those phases of Contractor performance which require substantial coordination with HUD personnel.

Section 3: Organization and Manpower. Include an organizational chart for the project showing the name of the project manager and the names of key personnel. Include a brief resume for each person shown on the special qualifications applicable to the performance of the project. Describe the specific effort to be contributed to the project by each of the key personnel and include a statement expressed either in percentages or man-hours that each will devote to the effort. Include a summation of the minimum man-hours or man-months of professional effort to be used in completing the project. Describe the physical facilities to be used. If consultants, advisors or subcontractors are to be used, describe the arrangements and include resumes of the key personnel.

Section 4: Prior and Current Experience. Include a list of projects currently in program and completed within the last two years which are relevant to the type of project effort proposed. Include names, addresses and telephone numbers of contact points with these clients. The Government reserves the right to request information from any source as needed.

(b) Part II - Cost and Pricing Data

Furnish cost or pricing data using the forms provided and labeled "Contract Pricing Proposal." Round all amounts to the nearest dollar. Also execute the "Certifications and Representations", and where appropriate, a "Certificate of Current Cost or Pricing Data". Both forms are provided. Furnish the names and telephone number of the Government audit organization having cognizance of your activity.

5. SIGNATURE

(a) The proposal shall be signed by an official authorized to bind the offeror, and shall contain a statement to the effect that the proposal is a firm offer for a 60-day (or more) period. The proposal shall also provide the following information:

HUD-770 (2-77)

(b) Name, title, address, and telephone number of individual(s) with authority to negotiate, and contractually bind the company, and also who may be contacted during the period of proposal evaluation.

6. NOTICE OF REQUIREMENT FOR CERTIFICATION OF NONSEGREGATED FACILITIES

Bidders and offerors are cautioned as follows: By signing this bid or offer, the bidder or offeror will be deemed to have signed and agreed to the provisions of the "Certification of Nonsegregated Facilities" in this solicitation. The certification provides that the bidder or offeror does not maintain or provide for his employees facilities which are segregated on a basis of race, creed, color, or national origin, whether such facilities are segregated by directive or on a de facto basis. The certification also provides that he will not maintain such segregated facilities. Failure of a bidder or offeror to agree to the Certification of Nonsegregated Facilities will render his bid or offer nonresponsive to the terms of solicitations involving awards of contracts exceeding \$10,000 which are not exempt from the provisions of the Equal Opportunity Clause.

7. RESPONSIBLE PROSPECTIVE CONTRACTORS

Contracts will be awarded only to responsible prospective Contractors. In order to qualify as responsible, a prospective Contractor must, in the opinion of the Contracting Officer, meet the following standards as they relate to this Request for Proposal.

- (a) Have adequate financial resources for performance, or have the ability to obtain such resources as required during performance;
- (b) Have the necessary experience, organization, technical qualifications, skills, and facilities, or have the ability to obtain them (including probable subcontractor arrangements);
- (c) Be able to comply with the proposed or required time of delivery or performance schedule;
- (d) Have a satisfactory record of performance;
- (e) Be able to comply with the requirements of the Equal Opportunity Clause;
- (f) Be otherwise qualified and eligible to receive an award under applicable laws and regulations.

8. RESPONSIVE PROPOSALS

(a) In order to be considered responsive, proposals must be accompanied by all certifications and representations included in this Request for Proposal.

(b) Offerors are required to complete and submit a Cost or Pricing Data as provided for above in paragraph 4.

PROPOSAL CONTENT AND OUTLINE

(c) Upon completion of negotiations, the successful offeror may be required to submit a Certificate of Current Cost or Pricing Data pursuant to FPR 1-3.807-3.

9. CONTRACT AWARD

(a) The Government may award a contract, based on offers received, without discussion of such offers. Accordingly, each offer should be submitted on the most favorable terms from a price and technical standpoint which the offeror can submit to the Government. However, the Government reserves the right to request additional data, or oral discussion or presentation, in support of written proposals.

(b) Any contract awarded as a result of this Request for Proposal will contain the special and general provisions made a part of this Request for Proposal.

10. LATE PROPOSALS, MODIFICATION OF PROPOSALS AND WITHDRAWAL OF PROPOSALS

(a) Any proposal received at the office designated in the solicitation after the exact time specified for receipt will not be considered unless it is received before quant is made, and:

(1) It was sent by registered or certified mail not later than the fifth calendar day prior to the date specified for receipt of offers (e.g., an offer submitted in response to a solicitation requiring receipt of offers by the 20th of the month must have been mailed by the 15th or earlier);

(2) It was sent by mail (or telegram if authorized) and it is determined by the Government that the late receipt was due solely to mishandling by the Government after receipt at the Government installation; or

(3) It is the only proposal received.

(b) Any modification of a proposal, except modification resulting from the Contracting Officer's request for "best and final" offer, is subject to the same conditions as in (a)(1) and (a)(2) of this provision.

(c) A modification resulting from the Contracting Officer's request for "best and final" offer received after the time and date specified in the request will not be considered unless received before award and the late receipt is due solely to mishandling by the Government after receipt at the Government installation.

(d) The only acceptable evidence to establish:

(1) The date of mailing of a late proposal or modification sent either by registered or certified mail in the U.S. Postal Service postmark on the wrapper or on the original receipt from the U.S. Postal Service. If neither postmark shows a legible date, the proposal or modification shall be deemed to have been mailed late. (The term "postmark" means a printed, stamped, or otherwise placed impression that is readily identifiable without further action as having been supplied and affixed on the date of mailing by employees of the U.S. Postal Service.)

(2) The time of receipt at the Government installation is the time-date stamp of such installation on the proposal wrapper or other documentary evidence of receipt maintained by the installation.

(e) Notwithstanding (a), (b), and (c) of this provision, a late modification of an otherwise successful proposal which makes its terms more favorable to the Government will be considered at any time it is received and may be accepted.

(f) Proposals may be withdrawn by writing of telegraphic notice received at any time prior to award. Proposals may be withdrawn in person by an offeror or his authorized representative, provided his identity is made known and he signs a receipt for the proposal prior to award.

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

ADDENDUM TO PROPOSAL INSTRUCTIONS AND CONDITIONS**10. LATE PROPOSAL MODIFICATIONS OR PROPOSALS
AND WITHDRAWALS OF PROPOSALS.**

(a) Any proposal received at the office designated in the solicitation after the exact time specified for receipt will not be considered unless it is received before award is made, and:

(1) It was sent by registered or certified mail not later than the fifth calendar day prior to the date specified for receipt of offers (e.g., an offer submitted in response to a solicitation requiring receipt of offers by the 20th day of the month must have been mailed by the 15th or earlier);

(2) It was sent by mail (or telegram if authorized) and it is determined by the Government that the late receipt was due solely to mishandling by the Government after receipt at the Government installation;

(3) It is the only proposal received; or

(4) It offers significant cost or technical advantages to the Government, and it is received before a determination of the competitive range has been made.

(b) Any modification of a proposal is subject to the same conditions as in (a) of this provision.

(c) The only acceptable evidence to establish:

(1) The date of mailing of a late proposal or modification sent either by registered mail or certified mail is the U. S. Postal Service postmark on the wrapper or on the original receipt from the U. S. Postal Service. If neither postmark shows legible date, the proposal or modification of proposal shall be deemed to have been mailed late. (The term "postmark" means a printed, stamped or otherwise placed impression that is readily identifiable without further action as having been supplied and affixed on the date of mailing by employees of the U.S. Postal Service.

(2) The time of receipt at the Government installation is the time-date stamp of such installation on the proposal wrapper or other documentary evidence of receipt maintained by the installation.

(d) Notwithstanding (a) and (b) of this provision, a late modification of an otherwise successful proposal which makes its terms more favorable to the Government will be considered at any time it is received and may be accepted.

(e) Proposals may be withdrawn by written or telegraphic notice received at any time prior to award. Proposals may be withdrawn in person by an offeror or his authorized representative, provided his identity is made known and he signs a receipt for the proposal prior to award.

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

GENERAL PROVISIONS

(Fixed-Price Contracts, other than Supply Contracts)

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1. DEFINITIONS

As used throughout this contract, the following terms shall have the meanings set forth below:

(a) The term "Secretary" means the Secretary or Under Secretary of the Department of Housing and Urban Development, and the term "his duly authorized representative" means any person or persons or board (other than the Contracting Officer) authorized to act for the Secretary.

(b) The term "Contracting Officer" means the person executing this contract on behalf of the Government, and any other officer or civilian employee who is a properly designated Contracting Officer, and the term includes, except as otherwise provided in this contract, the authorized representative of a Contracting Officer acting within the limits of his authority.

(c) Except as otherwise provided in this contract, the term "subcontracts" includes purchase orders under this contract.

(d) The term "HUD" means the Department of Housing and Urban Development.

2. PAYMENTS

The Contractor shall be paid, upon the submission of proper invoices or vouchers, the prices stipulated herein for work delivered or rendered and accepted, less deductions, if any, as herein provided. Unless otherwise specified, payment will be made upon acceptance of any

portion of the work delivered or rendered for which a price is separately stated in the contract.

3. STANDARDS OF WORK

The Contractor agrees that the performance of work and services pursuant to the requirements of this contract shall conform to high professional standards.

4. INSPECTION

(a) All work under this contract shall be subject to inspection and test by the Government, to the extent practicable, at all times (including the period of performance) and places, and in any event prior to acceptance. The Government through any authorized representative may inspect the premises of the Contractor or any subcontractor engaged in the performance of this contract.

(b) The Government may reject any work that is defective or otherwise not in conformity with the requirements of this contract. If the Contractor fails or is unable to correct or to replace such work within the time specified for delivery in this contract, or within a longer period of time authorized by the Contracting Officer, the Contracting Officer may accept such work at a reduction in price which is equitable under the circumstances. Failure to agree on the reduction in price shall be a dispute concerning a question of fact within the meaning of the clause of this contract entitled "Disputes."

5. ASSIGNMENT OF CLAIMS

(a) Pursuant to the provisions of the Assignment of Claims Act of 1940, as amended (31 U.S.C. 203, 41

U.S.C. 15), if this contract provides for payments aggregating \$1,000 or more, claims for moneys due or to become due the Contractor from the Government under this contract may be assigned to a bank, trust company, or other financing institution, including any Federal lending agency, and may thereafter be further assigned and reassigned to any such institution. Any such assignment or reassignment shall cover all amounts payable under this contract and not already paid, and shall not be made to more than one party, except that any such assignment or reassignment may be made to one party as agent or trustee for two or more parties participating in such financing. Unless otherwise provided in this contract, payments to assignee of any moneys due or to become due under this contract shall not, to the extent provided in said Act, as amended, be subject to reduction or setoff. (The preceding sentence applies only if this contract is made in time of war or national emergency as defined in said Act and is with the Department of Defense, the General Services Administration, the Atomic Energy Commission, the National Aeronautics and Space Administration, the Federal Aviation Agency, or any other department or agency of the United States designated by the President pursuant to Clause 4 of the proviso of section 1 of the Assignment of Claims Act of 1940, as amended by the Act of May 15, 1951, 65 Stat. 41.)

(b) In no event shall copies of this contract or of any plans, specifications, or other similar documents relating to work under this contract, if marked "Top Secret," "Secret," or "Confidential," be furnished to any assignee of any claim arising under this contract or to any other person not entitled to receive the same. However, a copy of any part or all of this contract so marked may be furnished, or any information contained therein may be disclosed, to such assignee upon the prior written authorization of the Contracting Officer.

6. EXAMINATION OF RECORDS

(a) The Contractor agrees that the Comptroller General of the United States or any of his duly authorized representatives or any duly authorized representatives of the Secretary or of the Contracting Officer shall, until expiration of 3 years after final payment under this contract or of the time periods for the particular records specified in Part 1-20 of the Federal Procurement Regulations (41 CFR Part 1-20), whichever expires earlier, have access to and the right to examine any directly pertinent books, documents, papers, and records of the Contractor involving transactions related to this contract.

(b) The Contractor further agrees to include in all his subcontracts hereunder a provision to the effect that the subcontractor agrees that the Comptroller General of the United States or any of his duly authorized representatives or any duly authorized representatives of the Secretary or of the Contracting Officer shall, until expiration of 3 years after final payment under the subcontract, or of the time periods for the particular records

specified in Part 1-20 of the Federal Procurement Regulations (41 CFR Part 1-20), whichever expires earlier, have access to and the right to examine any directly pertinent books, documents, papers, and records of such subcontractor, involving transactions related to the subcontract. The term "subcontract" as used in this clause excludes (1) purchase orders not exceeding \$2,500 and (2) subcontracts or purchase orders for public utility services at rates established for uniform applicability to the general public.

7. FEDERAL, STATE AND LOCAL TAXES

(a) As used throughout this clause, the term "contract date" means the date of this contract. As to additional supplies or services procured by modification of this contract, the term "contract date" means the date of such modification.

(b) Except as may be otherwise provided in this contract, the contract price includes, to the extent allocable to this contract, all Federal, State, and local taxes which, on the contract date:

(1) By Constitution, statute, or ordinance, are applicable to this contract, or to the transactions covered by this contract, or to property or interests in property; or

(2) Pursuant to written ruling or regulation, the authority charged with administering any such tax is assessing or applying to, and is not granting or honoring an exemption for, a contractor under this kind of contract, or the transactions covered by this contract, or property or interests in property.

(c) Except as may be otherwise provided in this contract, duties in effect on the contract date are included in the contract price, to the extent allocable to this contract.

(d) (1) If the Contractor is required to pay or bear the burden -

(i) Of any tax or duty which either was not to be included in the contract price pursuant to the requirements of paragraphs (b) and (c), or of a tax or duty specifically excluded from the contract price by a provision of this contract, or

(ii) Of an increase in rate of any tax or duty, whether or not such tax or duty was excluded from the contract price; or

(iii) Of any interest or penalty on any tax or duty referred to in (i) or (ii) above; the contract price shall be increased by the amount of such tax, duty, interest, or penalty allocable to this contract. Provided,

That the Contractor, if requested by the Contracting Officer, warrants in writing that no amount of such tax, duty, or rate increase was included in the contract price as a contingency reserve or otherwise, and *Provided further*, That liability for such tax, duty, rate increase, interest, or penalty was not incurred through the fault or negligence of the Contractor or his failure to follow instructions of the Contracting Officer.

(2) If the Contractor is not required to pay or bear the burden, or obtains a refund or drawback, in whole or in part, of any tax, duty, interest, or penalty which

(i) Was to be included in the contract price pursuant to the requirements of paragraphs (b) and (c),

(ii) Was included in the contract price, or

(iii) Was the basis of an increase in the contract price, the contract price shall be decreased by the amount of such relief, refund, or drawback allocable to this contract, or the allocable amount of such relief, refund, or drawback shall be paid to the Government, as directed by the Contracting Officer. The contract price also shall be similarly decreased if the Contractor, through his fault or negligence or his failure to follow instructions of the Contracting Officer, is required to pay or bear the burden, or does not obtain a refund or drawback of any such tax, duty, interest, or penalty. Interest paid or credited to the Contractor incident to a refund of taxes shall inure to the benefit of the Government to the extent that such interest was earned after the Contractor was paid or reimbursed by the Government for such taxes.

(3) Invoices or vouchers covering any adjustment of the contract price pursuant to this paragraph (d) shall set forth the amount thereof as a separate item and shall identify the particular tax or duty involved.

(4) This paragraph (d) shall not be applicable to social security taxes, income and franchise taxes, other than those levied on or measured by (i) sales or receipts from sales, or (ii) the Contractor's possession of, interest in, or use of property, title to which is in the Government, excess profits taxes, capital stock taxes, unemployment compensation taxes, or property taxes, other than such property taxes, allocable to this contract, as are assessed either on completed supplies covered by this contract or on the Contractor's possession of, interest in, or use of property title to which is in the Government.

(5) No adjustment pursuant to this paragraph (d) will be made under this contract unless the aggregate amount thereof is or may reasonably be expected to be over \$100.

(e) Unless there does not exist any reasonable basis to sustain an exemption, the Government upon request of

the Contractor, without further liability, agrees, except as otherwise provided in this contract, to furnish evidence appropriate to establish exemption from any tax which the Contractor warrants in writing was excluded from the contract price. In addition, the Contracting Officer may furnish evidence appropriate to establish exemption from any tax that may, pursuant to this clause, give rise to either an increase or decrease in the contract price. Except as otherwise provided in this contract, evidence appropriate to establish exemption from duties will be furnished only at the discretion of the Contracting Officer.

(f) (1) The Contractor shall promptly notify the Contracting Officer of all matters pertaining to Federal, State, and local taxes, and duties, that reasonably may be expected to result in either an increase or decrease in the contract price.

(2) Whenever an increase or decrease in the contract price may be required under this clause, the Contractor shall take action as directed by the Contracting Officer, and the contract price shall be equitably adjusted to cover the costs of such action, including any interest, penalty, and reasonable attorneys' fees.

8. UTILIZATION OF SMALL BUSINESS CONCERNS

(a) It is the policy of the Government as declared by the Congress that a fair proportion of the purchases and contracts for supplies and services for the Government be placed with small business concerns.

(b) The Contractor agrees to accomplish the maximum amount of subcontracting to small business concerns that the Contractor finds to be consistent with the efficient performance of this contract.

9. DEFAULT

(a) The Government may, subject to the provisions of paragraph (c) of this clause, by written notice of default to the Contractor, terminate the whole or any part of this contract in any one of the following circumstances:

(1) If the Contractor fails to perform the work called for by this contract within the time(s) specified herein or any extension thereof, or

(2) If the Contractor fails to perform any of the other provisions of this contract, or so fails to prosecute the work as to endanger performance of this contract in accordance with its terms, and in either of these two circumstances does not cure such failure within a period of 10 days (or such longer period as the Contracting Officer may authorize in writing) after receipt of notice from the Contracting Officer specifying such failure.

(b) In the event the Government terminates this contract in whole or in part as provided in paragraph (a) of this clause, the Government may procure, upon such terms and in such manner as the Contracting Officer may deem appropriate, work similar to the work so terminated and the Contractor shall be liable to the Government for any excess costs for such similar work. *Provided*, That the Contractor shall continue the performance of this contract to the extent not terminated under the provisions of this clause.

(c) Except with respect to defaults of subcontractors, the Contractor shall not be liable for any excess costs if the failure to perform the contract arises out of causes beyond the control and without the fault or negligence of the Contractor. Such causes may include, but are not restricted to, acts of God or of the public enemy, acts of the Government in either its sovereign or contractual capacity, fires, floods, epidemics, quarantine restrictions, strikes, freight embargoes, and unusually severe weather, but in every case the failure to perform must be beyond the control and without the fault or negligence of the Contractor. If the failure to perform is caused by the default of a subcontractor, and if such default arises out of causes beyond the control of both the Contractor and subcontractor and without the fault or negligence of either of them, the Contractor shall not be liable for any excess costs for failure to perform unless the supplies or services to be furnished by the subcontractor were obtainable from other sources in sufficient time to permit the Contractor to meet the required delivery scheduled or other performance requirements.

(d) If this contract is terminated as provided in paragraph (a) of this clause, the Government, in addition to any other rights provided in this clause, may require the Contractor to transfer title and deliver to the Government, in the manner and to the extent directed by the Contracting Officer, any of the completed or partially completed work not theretofore delivered in, and accepted by, the Government and any other property including contract rights, specifically produced or specifically acquired for the performance of such part of this contract as has been terminated, and the Contractor shall, upon the direction of the Contracting Officer, protect and preserve property in the possession of the Contractor in which the Government has an interest. The Government shall pay to the Contractor the contract price, if separately stated, for completed work accepted by the Government and the amount agreed upon by the Contractor and the Contracting Officer for (1) completed work for which no separate price is stated, (2) partially completed work, (3) other property described above which is accepted by the Government, and (4) the protection and preservation of property. Failure to agree shall be a dispute concerning a question of fact within the meaning of the clause of this contract entitled "Disputes." The Government may withhold from amounts otherwise due the Contractor for such completed supplies or manufacturing materials such sum as the Contracting Officer determines to be necessary to protect the Government

against loss because of outstanding liens or claims of former lien holders.

(e) If, after notice of termination of this contract under the provisions of this clause, it is determined for any reason that the Contractor was not in default under the provisions of this clause, or that the default was excusable under the provisions of this clause, the rights and obligations of the parties shall, if the contract contains a clause providing for termination for convenience of the Government, be the same as if the notice of termination had been issued pursuant to such clause. If, after notice of termination of this contract under the provisions of this clause, it is determined for any reason that the Contractor was not in default under the provisions of this clause, and if this contract does not contain a clause providing for termination for convenience of the Government, the Contract shall be equitably adjusted to compensate for such termination and the contract modified accordingly, failure to agree to any such adjustment shall be a dispute concerning a question of fact within the meaning of the clause of this contract entitled "Disputes."

(f) The right and remedies of the Government provided in this clause shall not be exclusive and are in addition to any other rights and remedies provided by law or under this contract.

(g) As used in paragraph (c) of this clause, the terms "subcontractor" and "subcontractors" mean subcontractor(s) at any tier.

10. TERMINATION FOR CONVENIENCE OF THE GOVERNMENT

(a) The performance of work under this contract may be terminated by the Government in accordance with this clause in whole, or from time to time in part, whenever the Contracting Officer shall determine that such termination is in the best interest of the Government. Any such termination shall be effected by delivery to the Contractor of a Notice of Termination specifying the extent to which performance of work under the contract is terminated, and the date upon which such termination becomes effective.

(b) After receipt of a Notice of Termination, and except as otherwise directed by the Contracting Officer, the Contractor shall:

(1) Stop work under the contract on the date and to the extent specified in the Notice of Termination;

(2) Place no further orders or subcontracts for materials, services, or facilities, except as may be necessary for completion of such portion of the work under the contract as is not terminated;

(3) Terminate all orders and subcontracts to the extent that they relate to the performance of work terminated by the Notice of Termination;

(4) Assign to the Government, in the manner, at the times, and to the extent directed by the Contracting Officer, all of the right, title, and interest of the Contractor under the orders and subcontracts so terminated, in which case the Government shall have the right, in its discretion, to settle or pay any or all claims arising out of the termination of such orders and subcontracts;

(5) Settle all outstanding liabilities and all claims arising out of such termination of orders and subcontracts, with the approval or ratification of the Contracting Officer, to the extent he may require, which approval or ratification shall be final for all the purposes of this clause;

(6) Transfer title to the Government and deliver in the manner, at the times, and to the extent, if any, directed by the Contracting Officer, (i) the fabricated or unfabricated parts, work in process, completed work, supplies, and other material produced as a part of, or acquired in connection with the performance of, the work terminated by the Notice of Termination, and (ii) the completed or partially completed plans, drawings, information and other property which, if the contract had been completed, would have been required to be furnished to the Government;

(7) Use his best efforts to sell, in the manner, at the times, to the extent, and at the price or prices directed or authorized by the Contracting Officer, any property of the types referred to in (6) above. *Provided, however,* That the Contractor (i) shall not be required to extend credit to any purchaser, and (ii) may acquire any such property under the conditions prescribed by and at a price or prices approved by the Contracting Officer. *And provided further,* That the proceeds of any such transfer or disposition shall be applied in reduction of any payments to be made by the Government to the Contractor under this contract or shall otherwise be credited to the price or cost of the work covered by this contract or paid in such other manner as the Contracting Officer may direct.

(8) Complete performance of such part of the work as shall not have been terminated by the Notice of Termination, and

(9) Take such action as may be necessary, or as the Contracting Officer may direct, for the protection and preservation of the property related to this contract which is in the possession of the Contractor and in which the Government has or may acquire an interest.

At any time after expiration of the plant clearance period, as defined in Subpart 1-8.1 of the Federal Procurement Regulations (41 CFR 1-8.1), as the definition may be amended from time to time, the Contractor may submit to the Contracting Officer a list, certified as to quantity and quality, of any or all items of termination inventory not previously disposed of, exclusive of items the disposition of which has been directed or authorized by the Contracting Officer, and may request the Govern-

ment to remove such items or enter into a storage agreement covering them. Not later than fifteen (15) days thereafter, the Government will acc. pt title to such items and remove them or enter into a storage agreement covering the same. *Provided,* That the list submitted shall be subject to verification by the Contracting Officer upon removal of the items or, if the items are stored, within forty-five (45) days from the date of submission of the list, and any necessary adjustment to correct the list as submitted shall be made prior to final settlement.

(c) After receipt of a Notice of Termination, the Contractor shall submit to the Contracting Officer his termination claim, in the form and with certification prescribed by the Contracting Officer. Such claim shall be submitted promptly but in no event later than one year from the effective date of termination, unless one or more extensions in writing are granted by the Contracting Officer upon request of the Contractor made in writing within such one-year period or authorized extension thereof. However, if the Contracting Officer determines that the facts justify such action, he may receive and act upon any such termination claim at any time after such one-year period or any extension thereof. Upon failure of the Contractor to submit his termination claim within the time allowed, the Contracting Officer may, subject to any review required by the contracting agency's procedures in effect as of the date of execution of this contract, determine on the basis of information available to him, the amount, if any, due to the Contractor by reason of the termination and shall thereupon pay to the Contractor the amount so determined.

(d) Subject to provisions of paragraph (c), and subject to any review required by the contracting agency's procedures in effect as of the date of execution of this contract, the Contractor and the Contracting Officer may agree upon the whole or any part of the amount or amounts to be paid to the Contractor by reason of the total or partial termination of work pursuant to this clause, which amount or amounts may include a reasonable allowance for profit on work done. *Provided,* That such agreed amount or amounts, exclusive of settlement costs, shall not exceed the total contract price as reduced by the amount of payments otherwise made and as further reduced by the contract price of work not terminated. The contract shall be amended accordingly, and the Contractor shall be paid the agreed amount. Nothing in paragraph (c) of this clause, prescribing the amount to be paid to the Contractor in the event of failure of the Contractor and the Contracting Officer to agree upon the whole amount to be paid to the Contractor by reason of the termination of work pursuant to this clause, shall be deemed to limit, restrict, or otherwise determine or affect the amount or amounts which may be agreed upon to be paid to the Contractor pursuant to this paragraph (d).

(e) In the event of the failure of the Contractor and the Contracting Officer to agree as provided in paragraph (d) upon the whole amount to be paid to the Contractor

by reason of the termination of work pursuant to this clause, the Contracting Officer shall, subject to any review required by the contracting agency's procedures in effect as of the date of execution of this contract, determine, on the basis of information available to him, the amount, if any, due to the Contractor by reason of the termination and shall pay to the Contractor the amounts determined as follows:

(1) For completed supplies accepted by the Government (or sold or acquired as provided in paragraph (b) (7) above) and not theretofore paid for, a sum equivalent to the aggregate price for such supplies computed in accordance with the price or prices specified in the contract, appropriately adjusted for any saving of freight or other charges;

(2) The total of -

(i) The costs incurred in the performance of the work terminated, including initial costs and preparatory expense allocable thereto, but exclusive of any costs attributable to supplies paid or to be paid for under paragraph (c) (1) hereof;

(ii) The cost of settling and paying claims arising out of the termination of work under subcontracts or orders, as provided in paragraph (b) (5) above, which are properly chargeable to the terminated portion of the contract (exclusive of amounts paid or payable on account of supplies or materials delivered or services furnished by subcontractors or vendors prior to the effective date of the Notice of Termination, which amounts shall be included in the costs payable under (i) above); and

(iii) A sum, as profit on (i), above, determined by the Contracting Officer pursuant to 1-8.303 of the Federal Procurement Regulations (41 CFR 1-8.303), in effect as of the date of execution of this contract, to be fair and reasonable. *Provided, however,* That if it appears that the contractor would have sustained a loss on the entire contract had it been completed, no profit shall be included or allowed under this subdivision (iii) and an appropriate adjustment shall be made reducing the amount of the settlement to reflect the indicated rate of loss; and

(3) The reasonable costs of settlement, including accounting, legal, clerical, and other expenses reasonably necessary for the preparation of settlement claims and supporting data with respect to the terminated portion of the contract and for the termination and settlement of subcontracts thereunder, together with reasonable storage, transportation, and other costs incurred in connection with the protection or disposition of property allocable to this contract.

The total sum to be paid to the Contractor under (1) and (2) of this paragraph (e) shall not exceed the total contract price as reduced by the amount of payments otherwise made and as further reduced by the contract

price of work not terminated. Except for normal spoilage, and except to the extent that the Government shall have otherwise expressly assumed the risk of loss, there shall be excluded from the amounts payable to the Contractor as provided in (e) (1) and (2) (i) above, the fair value, as determined by the Contracting Officer, of property which is destroyed, lost, stolen, or damaged so as to become undeliverable to the Government, or to a buyer pursuant to paragraph (b) (7).

(f) Any determination of costs under paragraph (c) or (e) hereof shall be governed by the principles for consideration of costs set forth in Subpart 1-15.2 of the Federal Procurement Regulations (41 CFR 1-15.2), as in effect on the date of this contract.

(g) The Contractor shall have the right to appeal, under the clause of this contract entitled "Disputes," from any determination made by the Contracting Officer under paragraph (c) or (e) above, except that, if the Contractor has failed to submit his claim within the time provided in paragraph (c) above and has failed to request extension of such time, he shall have no such right of appeal. In any case where the Contracting Officer has made a determination of the amount due under paragraph (c) or (e) above, the Government shall pay to the Contractor the following: (1) if there is no right of appeal hereunder or if no timely appeal has been taken, the amount so determined by the Contracting Officer; or (2) if an appeal has been taken, the amount finally determined on such appeal.

(h) In arriving at the amount due the Contractor under this clause there shall be deducted (1) all undischarged advance or other payments on account theretofore made to the Contractor, applicable to the terminated portion of this contract; (2) any claim which the Government may have against the Contractor in connection with this contract; and (3) the agreed price for, or the proceeds of sale of, any materials, supplies, or other things acquired by the Contractor or sold, pursuant to the provisions of this clause, and not otherwise recovered by or credited the Government.

(i) If the termination hereunder be partial, prior to the settlement of the terminated portion of this contract, the Contractor may file with the Contracting Officer a request in writing for an equitable adjustment of the price or prices specified in the contract relating to the continued portion of the contract (the portion not terminated by the Notice of Termination), and such equitable adjustment as may be agreed upon shall be made in such price or prices.

(j) The Government may from time to time, under such terms and conditions as it may prescribe, make partial payments and payments on account against costs incurred by the Contractor in connection with the terminated portion of this contract whenever in the opinion of the Contracting Officer the aggregate of such payments

shall be within the amount to which the Contractor will be entitled hereunder. If the total of such payments is in excess of the amount finally agreed or determined to be due under this clause, such excess shall be payable by the Contractor to the Government upon demand, together with interest computed at the rate of 6 percent per annum for the period from the date such excess payment is received by the Contractor to the date on which such excess is repaid to the Government: *Provided, however, That no interest shall be charged with respect to any such excess payment attributable to a reduction in the Contractor's claim by reason of retention or other disposition of termination inventory until ten days after the date of such retention or disposition, or such later date as determined by the Contracting Officer by reason of the circumstances.*

(k) Unless otherwise provided for in this contract, or by applicable statute, the Contractor, from the effective date of termination and for a period of three years after final settlement under this contract, shall preserve and make available to the Government at all reasonable times at the office of the Contractor but without direct charge to the Government, all his books, records, documents, and other evidence bearing on the costs and expenses of the Contractor under this contract and relating to the work terminated hereunder, or, to the extent approved by the Contracting Officer, photographs, microphotographs, or other authentic reproductions thereof.

11. DISPUTES

(a) Except as otherwise provided in this contract, any dispute concerning a question of fact arising under this contract which is not disposed of by agreement shall be decided by the Contracting Officer, who shall reduce his decision to writing and mail or otherwise furnish a copy thereof to the Contractor. The decision of the Contracting Officer shall be final and conclusive unless within 30 days from the date of receipt of such copy, the Contractor mails or otherwise furnishes to the Contracting Officer a written appeal addressed to the Secretary. The decision of the Secretary or his duly authorized representative for the determination of such appeals shall be final and conclusive unless determined by a court of competent jurisdiction to have been fraudulent, or capricious, or arbitrary, or so grossly erroneous as necessarily to imply bad faith, or not supported by substantial evidence. In connection with any appeal proceeding under this clause, the Contractor shall be afforded an opportunity to be heard and to offer evidence in support of its appeal. Pending final decision of a dispute hereunder, the Contractor shall proceed diligently with the performance of the contract and in accordance with the Contracting Officer's decision.

(b) This "Disputes" clause does not preclude consideration of law questions in connection with decisions provided for in paragraph (a) above: *Provided, That nothing in this contract shall be construed as making final*

the decision of any administrative official, representative, or board on a question of law.

12. BUY AMERICAN ACT SUPPLY AND SERVICE CONTRACTS

(a) In acquiring end products, the Buy American Act (41 U.S. Code 10a-4) provides that the Government give preference to domestic source and products. For the purpose of this clause:

(i) "Components" means those articles, materials, and supplies which are directly incorporated in the end products,

(ii) "End products" means those articles, materials, and supplies which are to be acquired under this contract for public use; and

(iii) A "domestic source end product" means (A) an unmanufactured end product which has been mined or produced in the United States and (B) an end product manufactured in the United States if the cost of the components thereof which are mined, produced, or manufactured in the United States exceeds 50 percent of the cost of all its components. For the purposes of this (a) (iii) (B), components of foreign origin of the same type or kind as the products referred to in (b) (i) or (ii) of this clause shall be treated as components mined, produced, or manufactured in the United States.

(b) The Contractor agrees that there will be delivered under this contract only domestic source end products, except end products:

(i) Which are for use outside the United States;

(ii) Which the Government determines are not mined, produced, or manufactured in the United States in sufficient and reasonably available commercial quantities and of a satisfactory quality;

(iii) As to which the Secretary determines the domestic preference to be inconsistent with the public interest, or

(iv) As to which the Secretary determines the cost to the Government to be unreasonable. (The foregoing requirements are administered in accordance with Executive Order No. 10582, dated December 17, 1954.)

13. CONVICT LABOR

In connection with the performance of work under this contract, the Contractor agrees not to employ any person undergoing sentence of imprisonment at hard labor

14. WALSH-HEALEY PUBLIC CONTRACTS ACT

If this contract is for the manufacture or furnishing of materials, supplies, articles, or equipment in an amount which exceeds or may exceed \$10,000 and is otherwise subject to the Walsh-Healey Public Contracts Act, as amended (41 U.S. Code 35-45), there are hereby incorporated by reference all representations and stipulations required by said Act and regulations issued thereunder by the Secretary of Labor, such representations and stipulations being subject to all applicable rulings and interpretations of the Secretary of Labor which are now or may hereafter be in effect.

15. CONTRACT WORK HOURS AND SAFETY STANDARDS ACT - OVERTIME COMPENSATION

This contract, to the extent that it is of a character specified in the Contract Work Hours and Safety Standards Act (40 U.S.C. 327-333), is subject to the following provisions and to all other applicable provisions and exceptions of such Act and the regulations of the Secretary of Labor thereunder.

(a) *Overtime requirements.* No Contractor or subcontractor contracting for any part of the contract work which may require or involve the employment of laborers or mechanics shall require or permit any laborer or mechanic in any workweek in which he is employed on such work to work in excess of eight hours in any calendar day or in excess of forty hours in such workweek on work subject to the provisions of the Contract Work Hours and Safety Standards Act unless such laborer or mechanic receives compensation at a rate not less than one and one-half times his basic rate of pay for all such hours worked in excess of eight hours in any calendar day or in excess of forty hours in such workweek, whichever is the greater number of overtime hours.

(b) *Violation; liability for unpaid wages; liquidated damages.* In the event of any violation of the provisions of paragraph (a) the Contractor and any subcontractor responsible therefor shall be liable to any affected employee for his unpaid wages. In addition, such Contractor and subcontractor shall be liable to the United States for liquidated damages. Such liquidated damages shall be computed with respect to each individual laborer or mechanic employed in violation of the provisions of paragraph (a) in the sum of \$10 for each calendar day on which such employee was required or permitted to be employed on such work in excess of eight hours or in excess of the standard workweek of forty hours without payment of the overtime wages required by paragraph (a).

(c) *Withholding for unpaid wages and liquidated damages.* The Contracting Officer may withhold from the Government Prime Contractor, any moneys payable on account of work performed by the Contractor or subcontractor, such sums as may administratively be determined to be necessary to satisfy any liabilities of each Contractor

or subcontractor for unpaid wages and liquidated damages as provided in the provisions of paragraph (b).

(d) *Subcontracts.* The Contractor shall insert paragraphs (a) through (d) of this clause in all subcontracts, and shall require their inclusion in all subcontracts of any tier.

(e) *Records.* The Contractor shall maintain payroll records containing the information specified in 29 CFR 516.2(a). Such records shall be preserved for three years from the completion of the contract.

16. EQUAL OPPORTUNITY

(The following clause is applicable unless this contract is exempt under the rules, regulations, and relevant orders of the Secretary of Labor (41 CFR, ch. 60).)

During the performance of this contract, the contractor agrees as follows:

(a) The Contractor will not discriminate against any employee or applicant for employment because of race, color, religion, sex, or national origin. The Contractor will take affirmative action to ensure that applicants are employed, and that employees are treated during employment, without regard to their race, color, religion, sex, or national origin. Such actions shall include, but not be limited to, the following: Employment, upgrading, demotion, or transfer; recruitment, or recruitment advertising; layoff or termination; rates of pay or other forms of compensation; and selection for training, including apprenticeship. The Contractor agrees to post in conspicuous places, available to employees and applicants for employment, notices to be provided by the Contracting Officer setting forth the provisions of this Equal Opportunity clause.

(b) The Contractor will, in all solicitations or advertisements for employees placed by or on behalf of the Contractor, state that all qualified applicants will receive consideration for employment without regard to race, color, religion, sex, or national origin.

(c) The Contractor will send to each labor union or representative of workers with which he has a collective bargaining agreement or other contract or understanding, a notice, to be provided by the agency Contracting Officer, advising the labor union or workers' representative of the Contractor's commitments under this Equal Opportunity clause, and shall post copies of the notice in conspicuous places available to employees and applicants for employment.

(d) The Contractor will comply with all provisions of Executive Order No. 11246 of September 24, 1965, and of the rules, regulations, and relevant orders of the Secretary of Labor.

(e) The Contractor will furnish all information and reports required by Executive Order No. 11246 of September 24, 1965, and by the rules, regulations, and orders of the Secretary of Labor, or pursuant thereto, and will permit access to his books, records, and accounts by the contracting agency and the Secretary of Labor for purposes of investigation to ascertain compliance with such rules, regulations, and orders.

(f) In the event of the Contractor's noncompliance with the Equal Opportunity clause of this contract or with any of the said rules, regulations, or orders, this contract may be canceled, terminated, or suspended, in whole or in part, and the Contractor may be declared ineligible for further Government contracts in accordance with procedures authorized in Executive Order No. 11246, of September 24, 1965, and such other sanctions may be imposed and remedies invoked as provided in Executive Order No. 11246, of September 24, 1965, or by rule, regulation, or order of the Secretary of Labor, or as otherwise provided by law.

(g) The Contractor will include the provisions of paragraphs (a) through (g) in every subcontract or purchase order unless exempted by rules, regulations, or orders of the Secretary of Labor issued pursuant to section 204 of Executive Order No. 11246 of September 24, 1965, so that such provisions will be binding upon each subcontractor or vendor. The Contractor will take such action with respect to any subcontract or purchase order as the contracting agency may direct as a means of enforcing such provisions, including sanctions for non-compliance. *Provided, however,* That in the event the contractor becomes involved in, or is threatened with, litigation with a subcontractor or vendor as a result of such direction by the contracting agency, the Contractor may request the United States to enter into such litigation to protect the interests of the United States.

17 OFFICIALS NOT TO BENEFIT

No member of or delegate to Congress, or resident commissioner, shall be admitted to any share or part of this contract, or to any benefit that may arise therefrom, but this provision shall not be construed to extend to this contract if made with a corporation for its general benefit.

18 COVENANT AGAINST CONTINGENT FEES

The Contractor warrants that no person or selling agency has been employed or retained to solicit or secure this contract upon an agreement or understanding for a commission, percentage, brokerage, or contingent fee, excepting bona fide employees or bona fide established commercial or selling agencies maintained by the Contractor for the purpose of securing business. For breach or violation of this warranty the Government shall have the right to annul this contract without liability or in its discretion to deduct from the contract price or considera-

tion, or otherwise recover, the full amount of such commission, percentage, brokerage, or contingent fee.

19. NOTICE AND ASSISTANCE REGARDING PATENT AND COPYRIGHT INFRINGEMENT

(a) The Contractor shall report to the Contracting Officer, promptly and in reasonable written detail, such notice or claim of patent or copyright infringement based on the performance of this contract of which the Contractor has knowledge.

(b) In the event of any claim or suit against the Government, on account of any alleged patent or copyright infringement arising out of the performance of this contract or out of the use of any supplies furnished, or work or services performed hereunder, the Contractor shall furnish to the Government, when requested by the Contracting Officer, all evidence and information in possession of the Contractor pertaining to such suit or claim. Such evidence and information shall be furnished at the expense of the Government except where the Contractor has agreed to indemnify the Government.

20. UTILIZATION OF LABOR SURPLUS AREA CONCERNS

(The following clause is applicable if this contract exceeds \$5,000.)

(a) It is the policy of the Government to award contracts to labor surplus area concerns that (1) have been certified by the Secretary of Labor (hereafter referred to as certified-eligible concerns with first or second preferences) regarding the employment of a proportionate number of disadvantaged individuals and have agreed to perform substantially (i) in or near sections of concentrated unemployment or underemployment or in persistent or substantial labor surplus areas or (ii) in other areas of the United States, respectively, or (2) are noncertified concerns which have agreed to perform substantially in persistent or substantial labor surplus areas, where this can be done consistent with the efficient performance of the contract and at prices no higher than are obtainable elsewhere. The Contractor agrees to use his best efforts to place his subcontracts in accordance with this policy.

(b) In complying with paragraph (a) of this clause and with paragraph (b) of the clause of this contract entitled "Utilization of Small Business Concerns" the Contractor in placing his subcontracts shall observe the following order of preference: (1) Certified-eligible concerns with a first preference which are also small business concerns, (2) other certified-eligible concerns with a first preference, (3) certified-eligible concerns with a second preference which are also small business concerns, (4) other certified-eligible concerns with a second preference, (5) persistent or substantial labor surplus area concerns which are also small business concerns, (6) other persistent or substantial labor surplus area concerns, and (7)

small business concerns which are not labor surplus area concerns.

21. GOVERNMENT PROPERTY

(a) *Government-Furnished Property.* The Government shall deliver to the Contractor, for use in connection with and under the terms of this contract, the property described as Government-furnished property in the Schedule or specifications, together with such related data and information as the Contractor may request and as may reasonably be required for the intended use of such property (hereinafter referred to as "Government-furnished property"). The delivery or performance dates for the supplies or services to be furnished by the Contractor under this contract are based upon the expectation that Government-furnished property suitable for use (except for such property furnished "as is") will be delivered to the Contractor at the times stated in the Schedule or, if not so stated, in sufficient time to enable the Contractor to meet such delivery or performance dates. In the event that Government-furnished property is not delivered to the Contractor by such time or times, the Contracting Officer shall, upon timely written request made by the Contractor, make a determination of the delay, if any, occasioned the Contractor thereby, and shall equitably adjust the delivery or performance dates or the contract price, or both, and any other contractual provision affected by any such delay in accordance with the procedure provided for in the clause of this contract entitled "Changes." Except for Government-furnished property furnished "as is", in the event the Government-furnished property is received by the Contractor in a condition not suitable for the intended use the Contractor shall, upon receipt thereof, notify the Contracting Officer of such fact and, as directed by the Contracting Officer, either (i) return such property at the Government's expense or otherwise dispose of the property, or (ii) effect repairs or modifications. Upon the completion of (i) or (ii) above, the Contracting Officer upon written request of the Contractor shall equitably adjust the delivery or performance dates or the contract price, or both, and any other contractual provision affected by the rejection or disposition, or the repair or modification, in accordance with the procedure provided for in the clause of this contract entitled "Changes." The foregoing provisions for adjustment are exclusive and the Government shall not be liable to suit for breach of contract by reason of any delay in delivery of Government-furnished property or delivery of such property in a condition not suitable for its intended use.

(b) *Changes in Government-Furnished Property.*

(1) By notice in writing, the Contracting Officer may (i) decrease the property provided or to be provided by the Government under this contract, or (ii) substitute other Government-owned property for property to be provided by the Government, or to be acquired by the Contractor for the Government, under this contract. The

Contractor shall promptly take such action as the Contracting Officer may direct with respect to the removal and shipping of property covered by such notice.

(2) In the event of any decrease in or substitution of property pursuant to subparagraph (1) above, or any withdrawal of authority to use property provided under any other contract or lease, which property the Government had agreed in the Schedule to make available for the performance of this contract, the Contracting Officer, upon the written request of the Contractor (or, if the substitution of property causes a decrease in the cost of performance, on his own initiative), shall equitably adjust such contractual provisions as may be affected by the decrease, substitution, or withdrawal, in accordance with the procedure provided for in the "Changes" clause of this contract.

(c) *Title.* Title to all property furnished by the Government shall remain in the Government. In order to define the obligations of the parties under this clause, title to each item of facilities, special test equipment, and special tooling (other than that subject to a "Special Tooling" clause) acquired by the Contractor for the Government pursuant to this contract shall pass to and vest in the Government when its use in the performance of this contract commences, or upon payment therefor by the Government, whichever is earlier, whether or not title previously vested. All Government-furnished property, together with all property acquired by the Contractor title to which vests in the Government under this paragraph, is subject to the provisions of this clause and is hereinafter collectively referred to as "Government property". Title to Government property shall not be affected by the incorporation or attachment thereof to any property not owned by the Government, nor shall such Government property, or any part thereof, be or become a fixture or lose its identity as personality by reason of affixation to any realty.

(d) *Use of Government Property.* The Government property shall, unless otherwise provided herein or approved by the Contracting Officer, be used only for the performance of this contract.

(e) *Utilization, Maintenance and Repair of Government Property.* The Contractor shall maintain and administer, in accordance with sound industrial practice, a program for the utilization, maintenance, protection and preservation of Government property, until disposed of by the Contractor in accordance with this clause. In the event that any damage occurs to Government property the risk of which has been assumed by the Government under this contract, the Government shall replace such items or the Contractor shall make such repair of the property as the Government directs; Provided, however, that if the Contractor cannot effect such repair within the time required, the Contractor shall dispose of such property in the manner directed by the Contracting Officer. The contract price includes no compensation to the

Contractor for the performance of any repair or replacement for which the Government is responsible, and an equitable adjustment will be made in any contractual provisions affected by such repair or replacement of Government property made at the direction of the Government, in accordance with the procedures provided for in the "Changes" clause of this contract. Any repair or replacement for which the Contractor is responsible under the provisions of this contract shall be accomplished by the Contractor at his own expense.

(f) *Risk of Loss.* Unless otherwise provided in this contract, the Contractor assumes the risk of, and shall be responsible for, any loss of or damage to Government property provided under this contract upon its delivery to him or upon passage of title thereto to the Government as provided in paragraph (c) hereof, except for reasonable wear and tear and except to the extent that such property is consumed in the performance of this contract.

(g) *Access.* The Government, and any persons designated by it, shall at all reasonable times have access to the premises wherein any Government property is located, for the purpose of inspecting the Government property.

(h) *Final Accounting and Disposition of Government Property.* Upon the completion of this contract, or such earlier dates as may be fixed by the Contracting Officer, the Contractor shall submit, in a form acceptable to the Contracting Officer, inventory schedules covering all items of Government property not consumed in the performance of this contract (including any resulting scrap) or not theretofore delivered to the Government, and shall prepare for shipment, deliver f.o.b. destination, or dispose of the Government property, as may be directed or authorized by the Contracting Officer. The net proceeds of any such disposal shall be credited to the contract price or shall be paid in such other manner as the Contracting Officer may direct.

(i) *Restoration of Contractor's Premises.* Unless otherwise provided herein, the Government, (1) may abandon any Government property in place, and thereupon all obligations of the Government regarding such abandoned property shall cease, and (2) has no obligation to the Contractor with regard to restoration or rehabilitation of the Contractor's premises, neither in case of abandonment (paragraph (i) (1) above), disposition on completion of need or of the contract (paragraph (h) above), nor otherwise, except for restoration or rehabilitation costs which are properly included in an equitable adjustment under paragraph (b) above.

(j) *Communications.* All communications issued pursuant to this clause shall be in writing.

22. SUBCONTRACTS

No contract shall be made by the Contractor with any other party for furnishing any of the completed or

substantially completed articles, or work herein contracted for without the written approval of the Contracting Officer as to sources.

23. KEY PERSONNEL

The personnel specified in an attachment to this contract are considered to be essential to the work being performed hereunder. Prior to diverting any of the specified individuals to other programs, the Contractor shall notify the Contracting Officer reasonably in advance and shall submit justification (including proposed substitutions) in sufficient detail to permit evaluation of the impact on the program. No diversion shall be made by the Contractor without the written consent of the Contracting Officer. Provided, That the Contracting Officer may ratify in writing such diversion and such ratification shall constitute the consent of the Contracting Officer required by this clause. The attachment to this contract may be amended from time to time during the course of the contract to either add or delete personnel, as appropriate.

24. CHANGES

The Contracting Officer may at any time, by a written order, and without notice to the sureties, make changes within the general scope of this contract, in any one or more of the following: (i) Drawings, designs, or specifications, where the supplies to be furnished are to be specially manufactured for the Government in accordance therewith, (ii) method of shipment or packing, and (iii) place of delivery. If any such change causes an increase or decrease in the cost of, or the time required for, the performance of any part of the work under this contract, whether changed or not changed by any such order, an equitable adjustment shall be made in the contract price or delivery schedule, or both, and the contract shall be modified in writing accordingly. Any claim by the Contractor for adjustment under this clause must be asserted within 30 days from the date of receipt by the Contractor of the notification of change. Provided, however, That the Contracting Officer, if he decides that the facts justify such action, may receive and act upon any such claim asserted at any time prior to final payment under this contract. Where the cost of property made obsolete or excess as a result of a change is included in the Contractor's claim for adjustment, the Contracting Officer shall have the right to prescribe the manner of disposition of such property. Failure to agree to any adjustment shall be a dispute concerning a question of fact within the meaning of the clause of this contract entitled "Disputes." However, nothing in this clause shall excuse the Contractor from proceeding with the contract as changed.

25. PATENTS

(a) The patentable results of research and development and studies conducted under the contract and all information, designs, specifications, know-how, data, and findings developed in the performance of this contract

shall be made available to the public through dedication, assignment to the Government, or such other means as the Secretary of Housing and Urban Development shall determine. The Contractor agrees (1) to cooperate in the preparation and prosecution of any domestic or foreign patent applications which the Government may decide to undertake covering the subject matter above described, (2) to execute all papers requisite in the prosecution of such patent applications, including assignments to the United States and dedications, and (3) to secure the cooperation of Technical Personnel (each employee or consultant working under the administrative direction of the Contractor or any subcontractor hereunder) in the preparation and the execution of all such papers as may be required in the prosecution of such patent applications or in order to vest title in the subject matter involved in the United States, or to secure the right of free use to the public.

(b) Prior to final payment under this contract, the Contractor shall file a final report disclosing to the Contracting Officer all inventions, improvements, and discoveries developed in the performance of this contract, and shall certify on the last page of such report that to the best of his knowledge and belief such disclosure has been made therein or that there are no such unreported inventions.

(c) The Contractor shall include provisions appropriate to effectuate the purposes of this clause in all contracts of employment with persons who perform any part of the research or development or studies under this contract and in any consultants' agreements or subcontracts involving research or development or studies hereunder.

26. PUBLICATION

(a) *Definition.* For the purpose of this clause, "publication" includes (1) any document containing information intended for public consumption or (2) the act of, or any act which may result in, disclosing information to the public.

(b) *General.* The results of the research and development and studies conducted under this contract are to be made available to the public through dedication, assignment to the Government, or such other means as the Secretary of Housing and Urban Development shall determine, as required under title III of the Housing Act of 1948, as amended (12 U.S.C. 1701a).

(c) *Reports Furnished the Government.* All intermediate and final reports of the research and development and studies conducted hereunder shall indicate on the cover or other initial page that the research and development and studies forming the basis for the report were conducted pursuant to a contract with the Department of Housing and Urban Development. Such reports are official

Government property and may not be published or reproduced (in toto, in verbatim excerpt, or in form approximating either of them) as an unofficial paper or article. The Contractor or Technical Personnel (each employee or consultant working under the administrative direction of the Contractor or any subcontractor hereunder) may publish such reports in whole or in part in a non-Government publication only in accordance with this paragraph (c) and paragraph (e) (1) of this clause.

(d) *Publication by Government.* The Government shall have full right to publish all information, data, and findings developed as a result of the research and development and studies conducted hereunder.

(e) *Publication by Contractor or Technical Personnel.*

(1) *Publication in whole or in part of Contractor's reports furnished the Government.* Unless such reports have been placed in the public domain by Government publication, the Contractor or Technical Personnel (each employee or consultant working under the administrative direction of the Contractor or any subcontractor hereunder) may publish a report furnished the Government, in toto or in verbatim excerpt, but consistent with paragraph (c) of this clause may not secure copyright therein, subject to the following conditions, and the conditions in paragraph (e) (4) and paragraph (f):

(i) During the first six months after submission of the full final report, if written permission to publish is obtained from the Contracting Officer.

(ii) After six months following submission of the full final report, and if paragraph (e) (3) is inapplicable, if a foreword or footnote in the non-Government publication indicates the source of the verbatim material.

(2) *Publication, except verbatim excerpts, concerning or based in whole or in part on results of research and development and studies hereunder.* The Contractor or Technical Personnel may issue a publication concerning, or based in whole or in part on the results of, the research and development and studies conducted under this contract and may secure copyright therein but in so publishing is not authorized thereby to inhibit the unrestricted right of the Secretary of Housing and Urban Development to disclose or publish in such manner as he may deem to be in the public interest the results of such research and development and studies, subject to the following conditions and the requirement in paragraph (e) (4):

(i) During the first six months after submission of the full final report, and if paragraph (e) (3) is inapplicable, if written waiver of the waiting period is obtained from the Contracting Officer.

(ii) After six months following submission of the full final report, and if paragraph (c)(3) is inapplicable, subject to Government exercise of an option that the publication contain a foreword or initial footnote substantially as follows:

The (research) (development) (studies) forming (part of) the basis for this publication were conducted pursuant to a contract with the Department of Housing and Urban Development. The substance of such (research) (development) (studies) is dedicated to the public. The author and publisher are solely responsible for the accuracy of statements or interpretations contained herein.

(3) *General condition of HUD, determines that Contractor's final report contains patentable subject matter developed in contract performance.* If the Contracting Officer determines that the Contractor's full final report contains patentable subject matter developed in the performance of this contract and so notifies the Contractor in writing prior to six months from date of submission of such report, no publication of verbatim excerpts from Contractor's reports or publication concerning or based in whole or in part on the results of the research and development and studies hereunder shall be made without the written consent of the Contracting Officer.

(4) *Copies of Contractor and Technical Personnel publications to be furnished the Government.* The Contractor or Technical Personnel will furnish the Contracting Officer six (6) copies of any publications which are based in whole or in part on the research and development and studies conducted under this contract.

(f) *Administratively Confidential Information.* The Contractor shall not publish or otherwise disclose, except to the Government and except matters of public record, any information or data obtained hereunder from private individuals, organizations, or public agencies, in a publication whereby the information or data furnished by any particular person or establishment can be identified, except with the consent of such person or establishment (consistent with the inhibitions applicable to the Secretary of Housing and Urban Development under section 602(d) of the Housing Act of 1956, 12 U.S.C. 1701d-3(d)).

(g) *Inclusion of Provisions in Contractor's Agreements.* The Contractor shall include provisions appropriate to effectuate the purposes of this clause in all contracts of employment with persons who perform any part of the research or development or study under this contract and in any consultant's agreements or subcontracts involving research or development or study hereunder.

27 NOTICE TO THE GOVERNMENT REGARDING LATE DELIVERY

In the event the Contractor encounters difficulty in meeting performance requirements, or anticipates difficulty in complying with the contract delivery schedule or date, the Contractor shall immediately notify the Contracting Officer thereof in writing, giving pertinent details, including the date by which it expects to complete performance or make delivery. Provided, however, that this data shall be informational only in character and that receipt thereof shall not be construed as a waiver by the Government of any contract delivery schedule or date, or any rights or remedies provided by law or under this contract.

28. CERTIFICATION OF NONSEGREGATED FACILITIES

(Applicable to (1) contracts, (2) subcontracts, and (3) agreements with applicants who are themselves performing federally assisted construction contracts, exceeding \$10,000 which are not exempt from the provisions of the Equal Opportunity clause.)

By the submission of this bid, the bidder, offeror, applicant, or subcontractor certifies that he does not maintain or provide for his employees any segregated facilities at any of his establishments, and that he does not permit his employees to perform their services at any location, under his control, where segregated facilities are maintained. He certifies further that he will not maintain or provide for his employees any segregated facilities at any of his establishments, and that he will not permit his employees to perform their services at any location, under his control, where segregated facilities are maintained. The bidder, offeror, applicant, or subcontractor agrees that a breach of this certification is a violation of the Equal Opportunity clause in this contract. As used in this certification, the term "segregated facilities" means any waiting rooms, work areas, rest rooms and wash rooms, restaurants and other eating areas, time clocks, locker rooms and other storage or dressing areas, parking lots, drinking fountains, recreation or entertainment areas, transportation, and housing facilities provided for employees which are segregated by explicit directive or are in fact segregated on the basis of race, color, religion, or national origin, because of habit, local custom, or otherwise. He further agrees that (except where he has obtained identical certifications from proposed subcontractors for specific time periods) he will obtain identical certifications from proposed subcontractors prior to award of subcontracts exceeding \$10,000 which are not exempt from the provisions of the Equal Opportunity clause, that he will retain such certifications in his files, and that he will forward the following notice to such proposed subcontractors (except where the proposed

subcontractors have submitted identical certifications for specific time periods):

**NOTICE TO PROSPECTIVE SUBCONTRACTORS
OF REQUIREMENT FOR CERTIFICATIONS OF
NONSEGREGATED FACILITIES**

A Certification of Nons segregated Facilities must be submitted prior to the award of a subcontract exceeding \$10,000 which is not exempt from the provisions of the Equal Opportunity clause. The certification may be submitted either for each subcontract or for all subcontracts during a period (i.e., quarterly, semiannually, or annually).

NOTE: The penalty for making false statements in offers is prescribed in 18 U.S.C. 1001

29. DISPOSITION OF MATERIAL

Upon termination or completion of all work under this contract, the Contractor shall prepare for shipment, deliver f.o.b. destination, or dispose of all materials received from the Government and all residual materials produced in connection with the performance of this contract as may be directed by the Contracting Officer. All materials pro-

duced or required to be delivered under this contract shall become and remain the property of the Government.

30. INTEREST

Notwithstanding any other provision of this contract, unless paid within 30 days all amounts that become payable by the Contractor to the Government under this contract (net of any applicable tax credit under the Internal Revenue Code) shall bear interest at the rate of 6 percent per annum from the date due until paid (inclusive of interest). Said amounts shall be due upon the earliest one of (i) the date fixed pursuant to the contract, (ii) the date of the first written demand for payment, including demand consequent upon default termination, (iii) the date of transmittal by the Government to the Contractor of a proposed supplemental agreement to confirm the completed negotiations fixing the amount, or (iv) if this contract provides for revision of prices, the date of written notice to the contractor stating the amount of refund payable in connection with a pricing proposal or in connection with a negotiated pricing agreement not confirmed by contract supplement.

U. S. DEPARTMENT OF HOUSING & URBAN DEVELOPMENT
ADDITIONAL GENERAL PROVISIONS
 (Fixed-Price Contracts Other Than Supply)

1. PRICE REDUCTION FOR DEFECTIVE COST OR PRICING DATA

(a) If the Contracting Officer determines that any price, including profit or fee, negotiated in connection with this contract, is increased by any significant amount because the Contractor, or any subcontractor pursuant to the terms of this contract, furnished inaccurate cost or pricing data, then such price cost shall be reduced accordingly and the contract shall be modified in writing to reflect such reduction.

(b) Failure to agree to such reduction shall be a dispute concerning a question of fact within the meaning of the "Disputes" clause of this contract.

(NOTE: Since the contract is subject to reduction under this clause by reason of defective cost or pricing data submitted in connection with certain subcontracts it is expected that the contractor will wish to include a clause in each such subcontract requiring the subcontractor to appropriately indemnify the contractor. It is also suggested that any subcontract subject to such indemnification will generally require substantially similar indemnification for defective cost or pricing data required to be submitted by its lower tier subcontractors.)

2. AUDIT

(a) For purposes of verifying that certified cost or pricing data submitted in conjunction with the negotiation of this contract, any contract change or other modification involving an amount in excess of \$100,000, accurate, complete, and current, the Contracting Officer or his authorized representative shall, until the expiration of 3 years from the date of final payment under this contract, or of the time periods for the particular records specified in Part 1.20 of the Federal Acquisition Regulations (48 CFR Part 1.20) which ever expires earlier, have the right to examine those books, records, documents, papers, and other supporting data which involve transactions related to this contract, which will permit adequate evaluation of the cost or pricing data submitted, along with the computations and projections used therein.

(b) The Contractor agrees to insert this clause, including this paragraph (b), in all subcontracts hereunder which when entered into exceed \$100,000, less the price is based on adequate price competition, established catalog or market prices of commercial items sold in substantial quantities to the general public, or prices set by law or regulation. When inserted, change shall be made to designate the higher-tier subcontractor at the level involved as the contracting and certifying party, to add "of the Government prime contract" after "Contracting Officer" and add, at the end of as above the words, "provided that, in the event of any contract change or modification, such change or modification results from a change other than modification of the Government prime contract." In each such excepted subcontract hereunder which when entered into exceeds \$100,000, the Contractor shall insert the following clause.

AUDIT - PRICE ADJUSTMENTS

(a) This clause shall become operative only with respect to any change or other modification of this contract which involves price adjustment in excess of \$100,000 unless the price adjustment is based on adequate price competition, established catalog or market prices of commercial items sold in substantial quantities to the general public, or prices set by law or regulation. Provided, That such change or other modification to this contract results from change or other modification to the Government prime contract.

(b) For purposes of verifying that certified cost or pricing data submitted in conjunction with such contract change or modification is accurate, complete and current, the Contracting Officer of the Government prime contract, his authorized representatives, until the expiration of 3 years from the date of final payment under this contract, or of the time periods for the particular records specified in Part 1.20 of the Federal Acquisition Regulations (48 CFR Part 1.20), which ever expires earlier, have the right to examine those books, records, documents, papers, and other supporting data which involve transactions related to this contract, which will permit adequate evaluation of the cost or pricing data submitted, along with the computations and projections used therein.

(c) The subcontractor agrees to insert this clause, including this paragraph (c), in all subcontracts hereunder which when entered into exceed \$100,000.

3. SUBCONTRACTOR COST AND PRICING DATA

(a) The Contractor shall require subcontractors hereunder to submit in writing cost or pricing data under the following circumstances.

(1) Prior to award of any cost-reimbursement type, time and material, labor-hour, incentive, or price redeterminable subcontract, the price of which is expected to exceed \$100,000; and

(2) Prior to the award of any other subcontract, the price of which is expected to exceed \$100,000 or to the pricing of any subcontract change or other modification for which the price adjustment is expected to exceed \$100,000, where the price or price adjustment is not based on adequate price competition, established catalog or market prices of commercial items sold in substantial quantities to the general public, or prices set by law or regulation.

(b) The Contractor shall require subcontractors to certify, in substantially the same form as that used in the certificate by the Prime Contractor to the Government, that, to the best of their knowledge and belief, the cost and pricing data submitted under (a) above are accurate, complete and current as of the date of the execution, which date shall be the date of agreement on the negotiated price of the subcontract or subcontract change or modification.

(c) The Contractor shall insert the substance of this clause including this paragraph (c) in each of his cost-reimbursement type (time and material), labor-hour, price redeterminable and incentive subcontracts hereunder, and in any other subcontract hereunder which exceeds \$100,000 unless the price

thereof is based on adequate price competition, established catalog or market prices of commercial items sold in substantial quantities to the general public, prices set by law or regulation. In each such excepted subcontract hereunder which exceeds \$100,000, the Contractor shall insert the substance of the following law:

SUBCONTRACTOR COST AND PRICING DATA-PRICE ADJUSTMENTS

(a) Paragraphs (b) and (c) of this clause shall become operative in with respect to any change or other modification made pursuant to one or more provisions of this contract which involves a price adjustment in value of \$100,000. The requirements of this clause shall be limited to such price adjustments.

(b) The Contractor shall require subcontractors hereunder to submit cost or pricing data under the following circumstances:

(1) Prior to award of any cost-reimbursement type, time and material labor-hour incentive, or price redeterminable subcontract the price of which is expected to exceed \$100,000; and

(2) Prior to award of any other subcontract, the price of which is expected to exceed \$100,000, or to the pricing of any subcontract change or other modification for which the price adjustment is expected to exceed 100,000 where the price adjustment is not based on adequate price competition, established catalog market prices of commercial items sold in substantial quantities to the general public, or prices set by law or regulation.

(c) The Contractor shall require subcontractors to certify, in substantially the same form as that used in the Certificate by the Prime Contractor to the Government that to the best of their knowledge and belief the cost and pricing data submitted under (b) above are accurate, complete, and current as of the date of the execution, which date shall be as close as possible to the date of agreement on the negotiated price of the contract modification.

(d) The Contractor shall insert the substance of this clause including this paragraph (d) in each subcontract hereunder which exceeds \$100,000.

(NOTHING FURTHER ON THIS PAGE.)

ADDITIONAL GENERAL PROVISIONS

4. COST ACCOUNTING STANDARDS

(a) Unless the Cost Accounting Standards Board or the General Services Administration in the case of nondefense contracts, has prescribed rules or regulations exempting the Contractor or this contract from standards, rules, and regulations promulgated pursuant to 50 U.S.C. App. 2168 (P.L. 91-379, August 15, 1970), or other statutory authority, the Contractor, in connection with this contract shall:

(1) By submission of a Disclosure Statement, disclose in writing his cost accounting practices as required by regulations of the Cost Accounting Standards Board. The required disclosures must be made prior to contract award unless the Contracting Officer provides a written notice to the Contractor authorizing post award submission in accordance with regulations of the Cost Accounting Standards Board. The practices disclosed for this contract shall be the same as the practices currently disclosed and applied on all other contracts and subcontracts being performed by the Contractor and which contain this Cost Accounting Standards clause. If the Contractor has marked the Disclosure Statement to indicate that it contains trade secrets and commercial or financial information which is privileged and confidential, the Disclosure Statement will be protected and will not be released outside of the Government.

(2) Follow consistently the cost accounting practices disclosed pursuant to (1), above, in accumulating and reporting contract performance cost data concerning this contract. If any change in disclosed practices is made for the purposes of any contract or subcontract subject to Cost Accounting Standards Board requirements, the change must be applied prospectively to this contract, and the Disclosure Statement must be amended accordingly. If the contract price or cost allowance of this contract is affected by such changes, adjustment shall be made in accordance with subparagraph (a)(4) or (a)(5), below, as appropriate.

(3) Comply with all Cost Accounting Standards in effect on the date of award of this contract or if the Contractor has submitted cost or pricing data, on the date of final agreement on price as shown on the Contractor's signed certificate of current cost or pricing data. The Contractor shall also comply with any Cost Accounting Standard which hereafter becomes applicable to a contract or subcontract of the Contractor. Such compliance shall be required prospectively from the date of applicability to such contract or subcontract.

(4) (A) Agree to an equitable adjustment (as provided in the Changes Clause of this contract) if the contract cost is affected by a change which pursuant to (3) above the Contractor is required to make to his established cost accounting practices whether such practices are covered by a Disclosure Statement or not.

(B) Negotiate with the Contracting Officer to determine the terms and conditions under which a change to either a disclosed cost accounting practice or an established cost accounting practice, other than a change under (4)(A), above, may be made. A change to a practice may be proposed by either the Government or the Contractor, provided, however, that no agreement may be made under this provision that will increase costs paid by the United States under this contract.

(5) Agree to an adjustment of the contract price or cost allowance, as appropriate, if he or a subcontractor fails to comply with an applicable Cost Accounting Standard or to follow any practice disclosed pursuant to subparagraphs (a)(1) and (a)(2), above, and such failure results in any increased costs paid by the United States. Such adjustment shall provide for recovery of the increased costs to the United States together with interest thereon computed at the rate determined by the Secretary of the Treasury pursuant to P.L. 92-41, 85 Stat. 97, or 7 percent per annum, whichever is less, from the time the payment by the United States was made to the time the adjustment is effected.

(b) If the parties fail to agree whether the Contractor or a subcontractor has complied with an applicable Cost Accounting Standard, rule, or regulation of the Cost Accounting Standards Board and as to any cost adjustment demanded by the United States, such failure to agree shall be a dispute concerning a question of fact within the meaning of the Disputes clause of this contract.

(c) The Contractor shall permit any authorized representatives of the head of the agency, of the Cost Accounting Standards Board, or of the Comptroller General of the United States to examine and make copies of any documents, papers, or records relating to compliance with the requirements of this clause.

(d) The Contractor shall include in all negotiated subcontracts which he enters into the substance of this clause except paragraph (b), and shall require such inclusion in all other subcontracts of any tier, except that this requirement shall apply only to negotiated subcontracts in excess of \$100,000 where the price negotiated is not based on:

(i) Established catalog or market prices of commercial items sold in substantial quantities to the general public; or

(ii) Prices set by law or regulation, and except that the requirement shall not apply to negotiated subcontracts otherwise exempt from the requirement to accept the Cost Accounting Standards clause by reason of § 331.30(b) of Title 4, Code of Federal Regulations (4 CFR 331.30(b)) or § 1-3.1203 (a)(2) of Title 41, Code of Federal Regulations (41 CFR 1-3.203(a)(2)).

However, if this is a contract with an agency which permits subcontractors to appeal final decisions of the Contracting Officer directly to the head of the agency or his duly authorized representative, then the Contractor shall include the substance of paragraph (b) as well.

NOTE:

1. Subcontractor shall be required to submit their Disclosure Statements to the Contractor. However, if a subcontractor has previously submitted his Disclosure Statement to a Government Contracting Officer he may satisfy that requirement by certifying to the Contractor the date of such Statement and the address of the Contracting Officer.

2. In any case where a subcontractor determines that the Disclosure Statement information is privileged and confidential and declines to provide it to his Contractor or higher tier subcontractor, the Contractor may authorize direct submission of that subcontractor's Disclosure Statement to the same Government offices to which the Contractor was required to make submission of his Disclosure Statement. Such authorization shall in no way relieve the Contractor of liability as provided in paragraph (a) (5) of this clause. In view of the foregoing and since the contract may be subject to adjustment under this clause by reason of any failure to comply with rules, regulations and Standards of the Cost Accounting Standards Board in connection with covered subcontracts, it is expected that the Contractor may wish to include a clause in each such subcontract requiring the subcontractor to appropriately indemnify the Contractor. However, the inclusion of such a clause and the terms thereof are matter for negotiation and agreement between the Contractor and the subcontractor, provided that they do not conflict with the duties of the Contractor under its contract with the Government. It is also expected that any subcontractor subject to such indemnification will generally require substantially similar indemnification to be submitted by his subcontractors.

(e) The terms defined in Sec. 331.20 of Part 331 of Title 4, Code of Federal Regulations (4 CFR 331.20) shall have the same meanings herein. As there defined, "negotiated subcontract" means "any subcontract except a firm fixed-price subcontract made by a Contractor or subcontractor after receiving offers from at least two firms not associated with each other or such Contractor or subcontractor, providing (1) the solicitation to all competing firms is identical, (2) price is the only consideration in selecting the subcontractor from among the competing firms solicited, and (3) the lowest offer received in compliance with the solicitation from among those solicited is accepted."

5. ADMINISTRATION OF COST ACCOUNTING STANDARDS

For the purpose of administering Cost Accounting Standards requirements under this contract, the Contractor shall:

- (a) Submit to the cognizant contracting officer a description of the accounting change and the general dollar magnitude of the change to reflect the sum of all increases and the sum of all decreases for all contracts containing the Cost Accounting Standards clause:
 - (1) For any change in cost accounting practices required to comply with a new Cost Accounting Standard in accordance with paragraphs (a)(3) and (a)(4)(A) of the clause of this contract entitled "Cost Accounting Standards" within 60 days (or such other date as may be mutually agreed to) after award of a contract requiring such change,
 - (2) For any change to cost accounting practices proposed in accordance with paragraph (a)(4)(B) of the clause of this contract entitled "Cost Accounting Standards" not less than 60 days (or such other date as may be mutually agreed to) prior to the effective date of the proposed change; or
 - (3) For any failure to comply with an applicable Cost Accounting Standard or to follow a disclosed practice as contemplated by paragraph (a)(5) of the clause of this contract entitled "Cost Accounting Standards" within 60 days (or such other date as may be mutually agreed to) after the date of agreement of such noncompliance by the Contractor
- (b) Submit a cost impact proposal in the form and manner specified by the cognizant contracting officer within 60 days (or such other date as may be mutually agreed to) after the date of determination of the adequacy and compliance of a change submitted pursuant to (a)(1), (2), or (3) above.
- (c) Agree to appropriate contract and subcontract amendments to reflect adjustments established in accordance with paragraphs (a)(4) and (a)(5) of the clause of this contract entitled "Cost Accounting Standards."
- (d) Include the substance of this clause in all negotiated subcontracts containing the clause entitled "Cost Accounting Standards."

In addition, include a provision in these subcontracts which will require such subcontractors, within thirty (30) days after receipt of award, to submit the following information to the contracting officer cognizant of the subcontractor's facility:

- (1) Subcontractor's name and subcontract number,
- (2) Dollar amount and date of award,
- (3) Name of Contractor making the award, and
- (4) A statement as to whether the subcontractor has made or proposes to make any changes to accounting practices that affect prime contracts or subcontracts containing the Cost Accounting Standards clause, unless such changes have already been reported. If award of the subcontract results in making a Cost Accounting Standard(s) effective for the first time this shall also be reported
- (e) In the event an adjustment is required to be made to any subcontract hereunder, notify the cognizant contracting officer in writing of such adjustment and agree to an adjustment in the price or estimated cost and fee of this contract, as appropriate, based upon the adjustment established under the subcontract. Such notice shall be given within 30 days after receipt of the proposed subcontract adjustment, and shall include a proposal for adjustment to such higher tier subcontract.
- (f) When the Cost Accounting Standards clause and this clause are included in subcontracts, the term "contracting officer" shall be suitably altered to identify the purchaser.

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

ALTERATIONS TO GENERAL PROVISIONS

(Fixed-Price Contracts Other Than Supply)

General Provisions for Fixed Price Contracts Other Than Supply Contracts, HUD 736 (12-70) attached hereto is amended as follows:

- A. Clause 5, "EXAMINATION OF RECORDS" is deleted in its entirety, and the following clause is inserted:
- EXAMINATION OF RECORDS BY COMPTROLLER GENERAL**
- (a) This clause is applicable if the amount of this contract exceeds \$2,500 and was entered into by of negotiation, including small business restricted advertising, but is not applicable if this tract was entered into by means of formal advertising.
- (b) The Contractor agrees that the Comptroller General of the United States or any of his duly authorized representatives shall, until the expiration of 3 years after final payment under this contract or such lesser time specified in either appendix M of the Armed Services Procurement Regulations or the Federal Procurement Regulations Part 1-20 as appropriate have access to and the right to examine any directly pertinent books, documents, papers, and records of the Contractor involving transactions related to this contract
- (c) The Contractor further agrees to include in all his subcontracts hereunder provision to the effect that the subcontractor agrees that the Comptroller General of the United States or any of his duly authorized representatives shall until the expiration of years after final payment under the subcontract or such lesser time specified in either appendix M of the Armed Services Procurement Regulation or the Federal Procurement Regulations Part 1-20, appropriate have access to and the right to examine any directly pertinent books, documents, papers and records of such subcontractor involving transactions related to the subcontract. The term "subcontract" as used in this clause excludes (1) purchase orders not exceeding \$2,500 and (2) subcontracts or purchase orders for public utility services at rates established for uniform applicability to the general public.
- (d) The periods of access and examination described in (b) (c) above, for records which relate to (1) appeals under the "Disputes" clause of this contract (2) litigation or the settlement of claims arising out of the performance of this contract, (3) costs and expenses of this contract as to which exception has been taken by the Comptroller General or any of his duly authorized representatives, shall continue until such appeals, litigations, claims, or exceptions have been disposed of.
- B. A new clause number 6-a entitled, "EXAMINATION OF RECORDS BY HUD" is inserted in the index following clause 6 and preceding clause 7.
- C. A new clause 6-a entitled, "EXAMINATION OF RECORDS BY HUD" is added as follows:
- EXAMINATION OF RECORDS BY HUD**
- The provisions of clause 6, above, entitled, "EXAMINATION OF RECORDS BY COMPTROLLER GENERAL" extended to provide equal rights to duly authorized representatives of the Secretary or of the Contracting Officer.
- D. Clause 25 "PATENTS" is deleted in its entirety, and the following clause is inserted in lieu thereof:
- PATENTS**
- (a) All rights to the patentable results of research and development and studies conducted by the Contractor or its employees in the course of or under this contract and all information, designs, specifications, know-how, data, and findings developed in the performance of this contract shall belong to the Government and shall be made available to the public by such means as the Secretary shall determine.
- (b) The Contractor hereby agrees to do all things necessary to prepare and prosecute any domestic or foreign patent applications the Government may decide to undertake covering the subject matter described above or to carry out the determination of the Secretary with respect to such subject matter.
- (c) The Contractor shall obtain agreements appropriate to effectuate the purpose of this clause from all persons who perform any work under this contract.
- (d) The Contractor shall include in all subcontracts entered into under this contract provisions making all the provisions of this clause applicable to subcontractors and their employees
- (e) The Contractor may apply to the Secretary at any time for an assignment of rights in or exclusive or non-exclusive license for any or all of the subject matter described above. The Secretary will determine whether or not to grant such license in general accordance with the Government Patent Policy and any sub-

¹ HUD-736.2 (9-73) Previous version is obsolete

sequent revisions or interpretations thereof. The determinations of the Secretary in regard to such application shall not be considered a dispute under the Disputes clause.

(f) The Contractor shall file with the final report required by this contract a statement to the Contracting Officer disclosing whether any inventions, improvements or discoveries were developed in the performance of this contract and said statement shall disclose the nature of all such inventions, improvements and discoveries. The Contractor shall certify on the last page of such statement that to the best of his knowledge and belief such disclosure has been made therein. Failure to comply with the provisions of this paragraph shall constitute grounds for withholding of final payment.

- E. A new clause number 31 entitled, "UTILIZATION OF MINORITY BUSINESS ENTERPRISES" is added to the Index.
- F. A new clause number 31 entitled "UTILIZATION OF MINORITY BUSINESS ENTERPRISES" is added as follows and is applicable if this contract exceeds \$5,000:

UTILIZATION OF MINORITY BUSINESS ENTERPRISES

(a) It is the policy of the Government that minority business enterprises shall have the maximum practicable opportunity to participate in the performance of Government contracts.

(b) The Contractor agrees to his best efforts to carry out this policy in the award of his subcontracts to the fullest extent consistent with the efficient performance of this contract. As used in this contract, the term "minority business enterprise" means a business, at least 50 percent of which is owned by minority group members or, in case of publicly owned businesses, at least 51 percent of the stock of which is owned by minority group members. For the purposes of this definition minority group members are Negroes, Spanish-speaking American persons, American-Orientals, American-Indians, American-Alaskans, and American Aleuts. Contractors may rely on written representations by subcontractors regarding their status as minority business enterprises in lieu of an independent investigation.

- G. A new clause number 32 entitled, "LISTING OF EMPLOYMENT OPENINGS" is added to the Index.
- H. A new clause number 32 entitled, "LISTING OF EMPLOYMENT OPENINGS" is added as follows pursuant to 41 CFR 101-11.5 if this contract is for \$2,500 or more.

(a) The Contractor agrees, in order to provide special emphasis to the employment of qualified disabled veterans and veterans of the Vietnam era, that all suitable employment openings of the Contractor which exist at the time of the execution of this contract and those which during the performance of this contract including those not generated by this contract and including those occurring at an establishment other than the one wherein the contract is being performed but excluding those of independent-

ently operated corporate affiliates, shall be offered for listing at an appropriate local office of the State employment service system wherein the opening occurs and to provide such reports to such local office regarding employment openings and hires as may be required. Provided That if this contract is for less than 10,000 or if it is with a State or local government the reports set forth in paragraphs (c) and (d) are not required.

(b) Listing of employment openings with the employment service system pursuant to this clause shall be made at least concurrently with the use of any other recruitment service or effort and shall involve the normal obligations which attach to the placing of a bona fide job order including the acceptance of referrals of veterans and nonveterans. This listing of employment openings does not require the hiring of any particular job applicant or from any particular group of job applicants and nothing herein is intended to relieve the Contractor from any requirements in any statutes, Executive orders, or regulations regarding nondiscrimination in employment.

(c) The reports required by paragraph (c) of this clause shall include, but not be limited to, periodic reports which shall be filed at least quarterly with the appropriate local office or where the Contractor has more than one establishment in a State, with the service. Such reports shall indicate for each establishment (i) the number of individuals who were hired during the reporting period, (ii) the number of those hired who were disabled veterans and (iii) the number of those hired who were nondisabled veterans of the Vietnam era. The Contractor shall submit report within 30 days after the end of each reporting period wherein any performance is made under this contract. The Contractor shall maintain copies of the reports submitted until the expiration of one year after final payment under the contract during which time they shall be made available, upon request for examination by an authorized representative of the Contracting Officer or of the Secretary of Labor.

(d) Whenever the Contractor becomes contractually bound by the listing provisions of this clause he shall advise the employment service system in each State wherein he has establishments of the name and location of each such establishment in the State. As long as the Contractor is contractually bound to these provisions and has so advised the State employment system, there is not need to advise the State system of subsequent contracts. The Contractor may advise the State system when it is no longer bound by this contract clause.

(e) This clause does not apply to the listing of employment openings which occur and are filed outside the 50 States, the District of Columbia, the Commonwealth of Puerto Rico, Guam, and the Virgin Islands.

(f) This clause does not apply to openings which the Contractor proposes to fill from within his own organization or to fill

pursuant to a customary and traditional employer-union hiring arrangement. This exclusion does not apply to a particular opening once an employer decides to consider applicants outside of his own organization or employer-union arrangement for that opening.

(g) As used in this clause:

(1) "All suitable employment openings" includes, but is not limited to, openings which occur in the following job categories: Production and nonproduction; plant and office; laborers and mechanics; supervisory and nonsupervisory; technical; and executive, administrative, and professional openings which are compensated on a salary basis of less than \$18,000 per year. The TETA includes full-time employment, temporary employment of more than 3 days' duration and part-time employment. It does not include openings which the Contractor proposes to fill from within his own organization or to fill pursuant to a customary and traditional employer-union hiring arrangement.

(2) "Appropriate office of the State employment services system" means the local office of the Federal-State national system of public employment offices with assigned responsibility for serving the area of the establishment where the employment opening is to be filled, including the District of Columbia, the Commonwealth of Puerto Rico, Guam, and the Virgin Islands.

(3) "Openings which the Contractor proposes to fill from within his own organization" means employment openings for which no consideration will be given to persons outside the Contractor's own organization (including any affiliates, subsidiaries, and parent companies), and includes any openings which the Contractor proposes to fill from regularly established "recall" or "rehire" lists.

(4) "Openings which the Contractor proposes to fill pursuant to a customary and traditional employer-union hiring arrangement" means employment openings for which no consideration will be given to persons outside of special hiring arrangement, including openings which the contractor proposes to fill from union halls, which is part of the customary and traditional hiring relationship which exists between the Contractor and representatives of his employees.

(5) "Disabled veteran" means a person entitled to disability compensation under laws administered by the Veterans Administration for a disability rated at 30 percent or more or a persons whose discharge for release from active duty was for a disability incurred or aggravated in line of duty.

(6) "Veteran of the Vietnam era" means a person (A) who served on active duty with the Armed Forces for a period of more than 180 days, any part of which occurred after August 5, 1964 and was discharged released therefrom with other than a dishonorable discharge, or (ii) was discharged or released from active duty for service-connected disability if any part of such duty was performed after August 5, 1964, and (B) who was so discharged or released within the 48 months preceding his application for employment covered by this clause.

(h) If any disabled veteran or veteran of the Vietnam era believes that the Contractor (or any first-tier subcontractor) has failed or refuses to comply with the provisions of this contract clause relating to giving special emphasis in employment to veterans such veteran may file a complaint with the veterans' employment service office who will attempt to informally resolve the complaint and then refer the complaint with a report on the attempt to resolve the matter to the State office of the Veterans Employment Service of the Department of Labor. Such complaint shall then be promptly referred through the Regional Manpower Administrator to the Secretary of Labor who shall investigate such complaint and shall take such action thereon as the facts and circumstances warrant consistent with the terms of this contract and the laws and regulations applicable thereto.

(i) The Contractor agrees to place this clause (excluding this paragraph (i)) in any subcontract directly under this contract.

I. A new clause number 33 entitled, "PAYMENT OF INTEREST ON CONTRACTOR'S CLAIMS" is added to the Index.

J. A new clause number 33 entitled, "PAYMENT OF INTEREST ON CONTRACTOR'S CLAIMS" is added as follows:

PAYMENT OF INTEREST ON CONTRACTOR'S CLAIMS

(a) If an appeal is filed by the Contractor from a final decision of the Contracting Officer under the disputes clause of this contract, denying a claim arising under the contract, simple interest on the amount of the claim finally determined owed by the Government shall be payable to the Contractor. Such interest shall be at the rate determined by the Secretary of the Treasury pursuant to Public Law 92-41, 85 Stat. 97, from the date the Contractor furnishes to the Contracting Officer his written appeal under the disputes clause of this contract; to the date of (1) a final judgment by a court of competent jurisdiction, or (2) mailing to the Contractor of a supplemental agreement for execution either confirming completed negotiations between the parties or carrying out a decision of a board of contract appeals.

(b) Notwithstanding (a), above, (1) interest shall be applied only from the date payment was due, if such date is later than the filing of appeal and (2) interest shall not be paid for any period of time that the Contracting Officer determines the Contractor has unduly delayed in pursuing his remedies before a board of contract appeals or a court of competent jurisdiction.

K. A new clause number 34 entitled, "PRICING OF ADJUSTMENTS" is added to the Index.

L. A new clause number 34 entitled, "PRICING OF ADJUSTMENTS" is added as follows:

PRICING OF ADJUSTMENTS

When costs are a factor in any determination of a contract price adjustment pursuant to the "CHANGES" clause or any other provision of this contract, such costs shall be in accordance with the contract cost principles and procedures in Part 1-15 of the Federal Procurement Regulations (41 CFR 1-15) or section IV of the Armed Services Procurement Regulation in effect on the date of this contract.

[illegible]

See [Server for instructions and updates](#)

OPTIONAL FORM 40 (10-71)

INSTRUCTIONS TO OFFERORS

1. The purpose of this form is to provide a standard format by which the offeror submits to the Government a summary of incurred and estimated costs (and attached supporting information) suitable for detailed review and analysis. Prior to the award of a contract resulting from this proposal the offeror shall, under the conditions stated in FPR 1-3.807-3 be required to submit a Certificate of Current Cost or Pricing Data (see FPR 1-3.807-3(h) and 1-3.807-4).

2. In addition to the specific information required by this form, the offeror is expected, in good faith, to incorporate in and submit with this form any additional data, supporting schedules, or substantiation which are reasonably required for the conduct of an appropriate review and analysis in the light of the specific facts of this procurement. For effective negotiations, it is essential that there be a clear understanding of:

- a. The existing, verifiable data.
- b. The judgmental factors applied in projecting from known data to the unknown, and
- c. The contingencies used by the offeror in his proposed price.

In short, the offeror's estimating process itself needs to be disclosed.

FOOTNOTES

1. Enter in this column those necessary and reasonable costs which in the judgment of the offeror will properly be incurred in the efficient performance of the contract. Where any of the items in this column have already been incurred (e.g., on a letter contract or change order), describe them as an attached supporting schedule. Identify all sales and transfers between your plants, divisions, or organizations under a common control, which are included at other than the lowest of cost to the original transferee or current market price.

2. If less space is available to that available in Exhibit A is required, attach separate pages as necessary and identify as this "Reference" column the attachment to which the information supporting the specific cost element may be found. No standard format is provided; however, the cost or pricing data must be accurate, complete and correct, and the judgment factors used in projecting from the data to the unknown must be stated in sufficient detail to enable the Contracting Officer to evaluate the proposal. For example, provide the basis and for pricing materials such as by vendor quotations, shop estimates, or current prices; the reason for use of overhead rates which depart significantly from experienced rates (production volume, a planned major re-arrangement, etc.); or justification for an increase in labor rates (anticipated wage and salary increases, etc.). Identify and explain any contingencies which are included in the proposed price, such as anticipated costs of rejects and defective work, or anticipated technical difficulties.

3. When attachment of supporting cost or pricing data to this form is impracticable, the data will be described (with schedules or appendices) and made available to the contracting officer or his representative upon request.

4. The formats for the Cost Elements and the Proposed Contract Estimate are not intended as rigid requirements. These may be presented in different format with the prior approval of the Contracting Officer if requested for more effective and efficient presentation. In all other respects this form will be completed and submitted without change.

5. By submission of this proposal the offeror grants to the Contracting Officer, or his authorized representative, the right to examine, for the purpose of verifying the cost or pricing data submitted, those books, records, documents and other supporting data which will permit adequate evaluation of such cost or pricing data, along with the computer data and programs used therein. This right may be exercised in connection with any negotiations prior to contract award.

6. Indicate the rates used and provide an appropriate explanation. Where agreement has been reached with Government representatives on the use of forward pricing rates, describe the nature of the agreement. Provide the method of computation and application of your overhead expense, including cost breakdown and showing trends and budgetary data as necessary to provide a basis for evaluation of the reasonableness of proposed rates.

7. If the total cost estimated here is in excess of \$250, provide on a separate page the following information in each separate item of royalty or license fee: name and address of licensor; date of license agreement; patent number, patent application serial number, or other data on which the royalty is payable; brief description, including any part or model numbers of each contract item or component on which the royalty is payable; percentage or dollar rate of royalty per unit; unit price of contract item; number of units; and total dollar amount of royalties. In addition, if specifically requested by the contracting officer, a copy of the current license agreement and identification of applicable clauses of specific patents shall be provided.

8. Provide a list of principal items within each category indicating source or anticipated source, quantity, unit price, comparison obtained, and basis of establishing source and reasonableness of cost.

CONTINUATION OF EXHIBIT A—SUPPORTING SCHEDULE AND RESPONSE TO QUESTIONS B AND V

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

CERTIFICATIONS AND REPRESENTATIONS

Offerors must **COMPLETE, SIGN and ATTACH** this page, in single copy, to any bid or proposal submitted under the Solicitation identified above.

1. TYPE OF BUSINESS ORGANIZATION REPRESENTATION (Check appropriate box.)

Offeror represents that he operates as an ☐ individual, ☐ partnership, ☐ a non-profit organization, ☐ a corporation, incorporated under the laws of the State of _____.

2. SMALL BUSINESS REPRESENTATION (Check appropriate box.)

Offeror represents that he ☐ is, or ☐ is not, a small business concern. A small business concern for the purpose of Government procurement is a concern, including its affiliates, which is independently owned and operated, is not dominant in the field of operation in which it is bidding on Government contracts, and can further qualify under the criteria concerning number of employees, average annual receipts, or other criteria, as prescribed by the Small Business Administration. (See Code of Federal Regulations, Title 13, Part 131, as amended, which contains detailed industry definitions and related procedures.) Number of employees

3. CONTINGENT FEE REPRESENTATION (Check appropriate boxes.)

The offeror represents (a) that he ☐ has, ☐ has not, employed or retained any company or person (other than a full-time bona fide employee working solely for the bidder) to solicit or secure this contract and (b) that he ☐ has, ☐ has not, paid or agreed to pay any company or person (other than a full-time bona fide employee working solely for the bidder) any fee, commission, percentage or brokerage fee, contingent upon or resulting from the award of this contract, and agrees to furnish information relating to (a) and (b) above as requested by the Contracting Officer. (NOTE: For interpretation of the representation, including the term "bona fide employee" see Code of Federal Regulations, Title 41, Chapter 1, Subpart 1-1.5.)

4. CERTIFICATION OF INDEPENDENT PRICE DETERMINATION

(a) By submission of this proposal, each offeror certifies, and in the case of a joint proposal each party thereto certifies as to its own organization, that in connection with this procurement:

- (1) The prices in this proposal have been arrived at independently, without consultation, communication, or agreement, for the purpose of restricting competition, as to any matter relating to such prices with any other offeror or with any competitor.
- (2) Unless otherwise required by law, the prices which have been quoted in this proposal have not and will not knowingly be disclosed by the offeror prior to award directly or indirectly to any other offeror or to any competitor, and
- (3) No attempt has been made or will be made by the offeror to induce any other person or firm to submit or not to submit a proposal for the purpose of restricting competition.

(b) Each person signing this proposal certifies that

- (1) He is the person in the offeror's organization responsible within that organization for the decision as to the prices being offered herein and that he has not participated, and will not participate, in any action contrary to (a)(1) through (a)(3) above, or
- (2) (i) He is not the person in the offeror's organization responsible within that organization for the decision as to the prices being offered herein but that he has been authorized in writing to act as agent for the persons responsible for such decision in certifying that such persons have not participated, and will not participate, in any action contrary to (a)(1) through (a)(3) above, and as their agent does hereby so certify, and
(ii) he has not participated, and will not participate, in any action contrary to (a)(3) above,

(c) This certification is not applicable to a foreign offeror submitting a proposal for a contract which requires performance or delivery outside the United States, its possessions, and Puerto Rico.

(d) A proposal will not be considered for award where (a)(1), (a)(3) or (b) above has been deleted or modified. Where (a)(2) above has been deleted or modified, the proposal will not be considered for award unless the offeror furnishes with the proposal a signed statement which sets forth in detail the circumstances of the disclosure and the head of the agency, or his designee, determines that such disclosure was not made for the purpose of restricting competition.

5. EQUAL OPPORTUNITY REPRESENTATION

The offeror represents that he ☐ has, ☐ has not, participated in a previous contract or sub-contract subject to the Equal Opportunity clause herein; that he ☐ has, ☐ has not, filed all required compliance reports; and that representations indicating submission of required reports, signed by proposed subcontractors, will be obtained prior to subcontract award. (The above representations need not be submitted in connection with contracts or subcontracts which are exempt from the clause.)

6. AFFIRMATIVE ACTION COMPLIANCE PROGRAM REPRESENTATION

(a) The Contractor, his subcontractor(s) and their subcontractor(s) performing work under any contract resulting from this solicitation is required to have a written affirmative action compliance program for each of its establishments. This requirement is applicable to each prime contractor who has 50 or more employees and a contract of \$50,000 or more; each prime contractor and subcontractor shall require each subcontractor who has 50 or more employees and a subcontract of \$50,000 or more to develop a written affirmative action compliance program for each of its establishments.

(b) The required affirmative action compliance program shall provide in detail for specific steps to guarantee equal employment opportunity keyed to the problems and needs of members of minority groups, including, when there are deficiencies, the development of specific goals and time tables for the prompt achievement of full and equal employment opportunity. Each contractor shall include in his affirmative action compliance program a table of job classifications. This table shall include, but need not be limited to, job titles, principal duties (and auxiliary duties, if any) rates of pay, and where more than one rate of pay applies (because of length of time in the job or other factors), the applicable rates. The affirmative action compliance program shall be signed by an executive official of the contractor.

(c) The affirmative action compliance program must provide for the evaluation of utilization of minority group personnel, which shall include the following:

- (1) An analysis of minority group representation in all job categories;
- (2) An analysis of hiring practices for the past year, including recruitment sources and testing, to determine whether equal employment opportunity is being afforded in all job categories; and
- (3) An analysis of upgrading, transfer, and promotion for the past year to determine whether equal employment opportunity is being afforded.

(d) Within 120 days after the award of a contract resulting from this solicitation the Contractor, his subcontractor(s) and their subcontractor(s) which are required to have an affirmative action compliance program shall maintain a copy of separate affirmative action compliance program for each establishment, including evaluation of utilization of minority group personnel and the job classification tables, at each local office responsible for the personnel matters of each establishment. The program shall be a part of the manpower and training plans for each new establishment and shall be developed and made available prior to the staffing of such establishment. A report of the result of each program shall be compiled annually and the program shall be updated at that time.

(e) The offeror represents that he will make the above information available to the Assistant Secretary for Equal Opportunity, HHS or his duly authorized representative, or to the Director, Office of Federal Contract Compliance, DOL, upon request.

7. ESTABLISHMENT OF AFFIRMATIVE ACTION PROGRAMS

The bidder (or offeror) represents that (1) he ☐ has developed and has on file ☐ has not developed and does not have ☐ file at each establishment affirmative action programs as required by the rules and regulations of the Secretary of Labor (41 CFR 60-1 and 60-2), or (2) he ☐ has not previously had contracts subject to the written affirmative action program requirement of the rules and regulations of the Secretary of Labor.

Name and Title of Person Signing

Signature

Date

NOTE: Offerors must set forth full, accurate, and complete information as required by this solicitation (including attachments). The penalty for making false statements in offers is prescribed in 18 U. S. C. 1001.

CONTRACT PRICING PROPOSAL (RESTRICTED AND DEFERRED)				Office of Management and Budget Approval No. 28-RC1184	
This form is to be used when (1) submission of cost or pricing data (see FPMR (41 CFR) 101-11.6) is required and (2) submission for the optional form 99 is authorized by the contracting officer.				PAGE NO.	NO. OF PAGES
NAME OF OFFEROR		SUPPLY AND/OR SERVICES TO BE FURNISHED			
HOME OFFICE ADDRESS					
BRANCHES AND LOCATIONS WHERE WORK IS TO BE PERFORMED		TOTAL AMOUNT OF PROPOSAL		GOVT. REGISTRATION NO.	
DETAIL DESCRIPTION OF COST ELEMENTS					
1. DIRECT MATERIALS (Items on Exhibit A)			EST. COST (\$)	TOTAL EST. COST	REFER. PRICE
a. PURCHASED PARTS					
b. SUBCONTRACTED ITEMS					
c. OTHER: (1) RAW MATERIALS					
(2) FOUR STANDARD COMMERCIAL ITEMS					
(3) INTERNATIONAL TRANSPORT (if other than rail)					
TOTAL DIRECT MATERIALS					
2. MATERIAL OVERHEAD (Rate % of 100)					
3. DIRECT LABOR (If prices)			ESTIMATED HOURS	RATE/HOUR	EST. COST (\$)
TYPE OF SPECIAL LABOR					
4. LABOR OVERHEAD (Specify Department or Unit Code)			ON RATE	W. BASE	EST. COST (\$)
TOTAL LABOR OVERHEAD					
5. SPECIAL TESTING (Including field work at Government installations)			EST. COST (\$)		
TOTAL SPECIAL TESTING					
6. SPECIAL EQUIPMENT (If direct charge, (Items on Exhibit A))			EST. COST (\$)		
7. TRAVEL (If direct charge, (Items on Exhibit A))			EST. COST (\$)		
a. TRANSPORTATION					
b. PER DIEM OR SUBSISTENCE					
TOTAL TRAVEL					
8. CONSULTANTS (Specify - firm, rate)			EST. COST (\$)		
TOTAL CONSULTANTS					
9. OTHER DIRECT COSTS (Items on Exhibit A)					
TOTAL DIRECT COST AND OVERHEAD					
10. GENERAL AND ADMINISTRATIVE EXPENSE (Rate % of total direct cost)					
11. ROYALTIES					
12. TOTAL ESTIMATED COST					
13. FEE OR PROFIT					
TOTAL ESTIMATED COST AND FEE OR PROFIT					

CLEAN AIR AND WATER CERTIFICATION

(Applicable if the bid or offer exceeds \$100,000, or the Contracting Officer has determined that orders under an indefinite quantity contract in any year will exceed \$100,000, or a facility to be used has been the subject of a conviction under the Clean Air Act (42 U.S.C. 1857c-8(c)(1)) or the Federal Water Pollution Control Act (33 U.S.C. 1319(c)) and is listed by EPA, or is not otherwise exempt.)

The Bidder or Offeror certifies as follows:

- (a) Any facility to be utilized in the performance of this proposed contract has ☐, has not ☐, been listed on the Environmental Protection Agency list of violating facilities.
- (b) He will promptly notify the Contracting Officer, prior to award, of the receipt of any communication from the Director, Office of Federal Activities, U.S. Environmental Protection Agency, indicating that any facility which he proposes to use for the contract is under consideration to be listed on the EPA list of violating facilities.
- (c) He will include substantially this Certification, including this paragraph (c), in every non-exempt subcontract.

Signature	Title	Date
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CLEAN AIR AND WATER CLAUSES

(Applicable only if the contract exceeds \$100,000, or the Contracting Officer has determined that the orders under an indefinite quantity contract in any one year will exceed \$100,000, or a facility to be used has been the subject of a conviction under the Clean Air Act (42 U.S.C. 1857c-8(c) (1)) or the Federal Water Pollution Control Act (33 U.S.C. 1319(c)) and is listed by EPA, or the contract is not otherwise exempt.)

(a) The Contractor agrees as follows:

- (i) To comply with all the requirements of Section 114 of the Clean Air Act, as amended (42 U.S.C. 1857, Et Seq., as amended by Public Law 91-604) and Section 308 of the Federal Water Pollution Control Act (33 U.S.C. 1251, as amended by Public Law 92-500), respectively relating to inspection, monitoring, entry, reports, and information, as well as other requirements specified in Section 114 and Section 308 of the Air Act and the Water Act, respectively, and all regulations and guidelines issued thereunder before the award of this contract.
- (ii) That no portion of the work required by this prime contract will be performed in a facility listed on the Environmental Protection Agency list of violating facilities on the date when this contract was awarded unless and until the EPA eliminates the name of such facility or facilities from such listing.
- (iii) To use his best efforts to comply with Clean Air Standards and Clean Water Standards at the facilities in which the contract is being performed.
- (iv) To insert the substance of the provisions of this Clause in any non-exempt subcontract, including this paragraph (iv).

(b) The terms used in this Clause have the following meanings:

- (i) The term "Air Act" means the Clean Air Act, as amended (42 U.S.C. 1857 Et Seq., as amended by Public Law 91-604).

- (ii) The term "Water Act" means Federal Water Pollution Control Act, as amended (1) U.S.C. 1291 et seq., as amended by Public Law 92-500).
- (iii) The term "Clean Air Standards" means any enforceable rules, regulations, guidelines, standards, limitations, orders, controls, prohibitions, or other requirements which are contained in, issued under, or otherwise adopted pursuant to the Air Act or Executive Order 11738, an applicable implementation plan as described in Section 110 (d) of the Clean Air Act (42 U.S.C. 1857c-5(d)), an approved implementation procedure or plan under Section 111(c) or Section 111(d), respectively, of the Air Act (42 U.S.C. 1857c-6(c) or (d)), or an approved implementation procedure under Section 112(d) of the Air Act (42 U.S.C. 1857c-7(d)).
- (iv) The term "Clean Water Standards" means any enforceable limitation, control, condition, prohibition, standard, or other requirement which is promulgated pursuant to the Water Act or contained in a permit issued to a discharger by the Environmental Protection Agency or by a state under an approved program, as authorized by Section 402 of the Water Act (33 U.S.C. 1342), or by a local Government to ensure compliance with pretreatment regulations as required by Section 307 of the Water Act (33 U.S.C. 1317).
- (v) The term "Compliance" means compliance with Clean Air or Water Standards. Compliance shall also mean compliance with a schedule or plan ordered or approved by a court of competent jurisdiction, the Environmental Protection Agency or an Air or Water Pollution Control Agency in accordance with the requirement of the Air Act or Water Act and regulations issued pursuant thereto.
- (vi) The term "Facility" means any building, plant, installation, structure, mine, vessel, or other floating craft, location, or site or operations, owned, leased, or supervised by a contractor, subcontractor, to be utilized in the performance of a contract or subcontract. Where a location or site of operations contains or includes more than one building, plant, installation, or structure, the entire location shall be deemed to be a facility except where the Director, Office of Federal Activities, Environmental Protection Agency, determines that independent facilities are collocated in one geographical area.

**DISCLOSURE STATEMENT - COST ACCOUNTING
PRACTICES AND CERTIFICATION**

Any contract in excess of \$100,000 resulting from this solicitation except (1) when the price negotiated is based on (a) established catalog or market prices of commercial items sold in substantial quantities to the general public, or (b) prices set by law or regulation, or (2) contracts which are otherwise exempt (see 4 CFR 331.30(b) and FPR § 1-3.1203(a)(2)), shall be subject to the requirements of the Cost Accounting Standards Board. Any offeror submitting a proposal, which, if accepted, will result in a contract subject to the requirements of the Cost Accounting Standards Board must, as a condition of contracting, submit a Disclosure Statement as required by regulations of the Board. The Disclosure Statement must be submitted as a part of the offeror's proposal under this solicitation (see (I) below) unless (i) the offeror, together with all divisions, subsidiaries, and affiliates under common control, did not receive net awards of negotiated national defense prime contracts totaling more than \$30,000,000 in Federal Fiscal Year 1971 or net awards of negotiated national defense prime contracts of the type (as defined in the first sentence above) which are subject to Cost Accounting Standards totaling more than \$30,000,000 in either Federal Fiscal Year 1972 or 1973 (see (II) below), (ii) the offeror has already submitted a Disclosure Statement disclosing the practices used in connection with the pricing of this proposal (see (III) below), or (iii) post award submission has been authorized by the Contracting Officer. See 4 CFR 351.70 for submission of a copy of the Disclosure Statement to the Cost Accounting Standards Board.

CAUTION: A practice disclosed in a Disclosure Statement shall not, by virtue of such disclosure, be deemed to be a proper, approved, or agreed to practice for pricing proposals or accumulating and reporting contract performance cost data.

Check the appropriate box below:

☐ I. CERTIFICATE OF CONCURRENT SUBMISSION OF DISCLOSURE STATEMENT(S)

The offeror hereby certifies that he has submitted, as a part of his proposal under this solicitation, copies of the Disclosure Statement(s) as follows: (i) original and one copy to the cognizant Contracting Officer; and (ii) one copy to the cognizant contract auditor.

Date of
Disclosure Statement(s):

Name(s) and Address(es) of Cognizant
Contracting Officer(s) where filed:

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The offeror further certifies that practices used in estimating costs in pricing this proposal are consistent with the cost accounting practices disclosed in the Disclosure Statement(s).

☐ II. CERTIFICATE OF MONETARY EXEMPTION

The offeror hereby certifies that, together with all divisions, subsidiaries, and affiliates under common control, he did not receive net awards of negotiated national defense prime contracts totaling more than \$30,000,000 in Federal Fiscal Year 1971 or net awards of negotiated national defense prime contracts of the type which are subject to Cost Accounting Standards totaling more than \$10,000,000 in either Federal Fiscal Year 1972 or 1973.

☐ III. CERTIFICATE OF PREVIOUSLY SUBMITTED DISCLOSURE STATEMENT(S)

The offeror hereby certifies that the Disclosure Statement(s) were filed as follows:

Date of
Disclosure Statement(s):

Name(s) and Address(es) of Cognizant
Contracting Officer(s) where filed:

- : The offeror further certifies that practices used in estimating costs in pricing this proposal are consistent with the cost accounting practices disclosed in the Disclosure Statement(s).

**COST ACCOUNTING STANDARDS -- EXEMPTION FOR
CONTRACTS OF \$500,000 OR LESS -- CERTIFICATION**

If this proposal is expected to result in the award of a contract of \$500,000 or less and the offeror is otherwise eligible for an exemption, he shall indicate by checking the box below that the exemption to the Cost Accounting Standards clause (FPR § 1-3.1204) under the provisions of 4 CFR 331.30(b)(8) (see FPR § 1-3.1203(h)) is claimed. Where the offeror fails to check the box, he shall be given the opportunity to make an election in writing to the Contracting Officer prior to award. Failure to check the box below or make such an election shall mean that the offeror cannot claim the exemption to the Cost Accounting Standards clause or that the offeror elects to comply with such clause.

☐ CERTIFICATE OF EXEMPTION FOR CONTRACTS OF \$500,000 OR LESS

The offeror hereby claims an exemption from the Cost Accounting Standards clause under the provisions of 4 CFR 331.30(B)(8) and certifies that he has received notification of final acceptance of all items or work

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on (i) any prime contract or subcontract in excess of \$500,000 which contains the Cost Accounting Standards clause, and (ii) any prime contract or subcontract of \$500,000 or less awarded after January 1, 1975, which contains the Cost Accounting Standards clause. The offeror further certifies he will immediately notify the contracting officer in writing in the event he is awarded any other contract or subcontract containing the Cost Accounting Standards Clause subsequent to the date of this certificate but prior to the date of any award resulting from this proposal.

**ADDITIONAL COST ACCOUNTING STANDARDS APPLICABLE
TO EXISTING CONTRACTS--CERTIFICATION**

- (a) Cost accounting standards will be applicable and effective as promulgated by the Cost Accounting Standards Board to any award as provided in the Federal Procurement Regulations Subpart 1-3.12. If the offeror presently has contracts or subcontracts containing the Cost Accounting Standards clause, a new standard becomes applicable to such existing contracts prospectively when a new contract or subcontract containing such clause is awarded on or after the effective date of such new standard. Such new standard may require a change in the offeror's established cost accounting practices, whether or not disclosed. The offeror shall specify by an appropriate entry below, the effect on his cost accounting practice.
- (b) The offeror hereby certifies that an award under this solicitation () would, () would not, in accordance with paragraph (a)(3) of the Cost Accounting Standards clause require a change in his established cost accounting practices affecting existing contracts and subcontracts.

NOTE: If the offeror has checked "would" above, and is awarded the contemplated contract, he will also be required to comply with the clause entitled Administration of Cost Accounting Standards.

TO BE COMPLETED BY OFFEROR:

Name of Offeror	Date
By (signature)	Title

EMPLOYMENT OF THE HANDICAPPED

(a) The contractor will not discriminate against any employee or applicant for employment because of physical or mental handicap in regard to any position for which the employee or applicant for employment is qualified. The contractor agrees to take affirmative action to employ, advance in employment and otherwise treat qualified handicapped individuals without discrimination based upon their physical or mental handicap in all employment practices such as the following: employment, upgrading, demotion or transfer, recruitment, advertising, layoff or termination, rates of pay or other forms of compensation, selection for training including apprenticeship.

(b) The contractor agrees to comply with the rules, regulations, and relevant orders of the Secretary of Labor issued pursuant to the Rehabilitation Act of 1973, as amended.

(c) In the event of the contractor's noncompliance with the requirements of this clause, actions for noncompliance may be taken in accordance with the rules, regulations and relevant orders of the Secretary of Labor issued pursuant to the Act.

(d) The contractor agrees to post in conspicuous places, available to employees and applicants for employment, notices in a form to be prescribed by the Director, Office of Federal Contract Compliance Programs, Department of Labor, provided by or through the contracting officer. Such notices shall state the contractor's obligation under the law to take affirmative action to employ and advance in employment qualified handicapped employees and applicants for employment, and the rights of applicants and employees.

(e) The contractor will notify each labor union or representative of workers with which it has a collective bargaining agreement or other contract understanding, that the contractor is bound by the terms of section 503 of the Act and is committed to take affirmative action to employ and advance in employment physically and mentally handicapped individuals.

(f) The contractor will include the provisions of this clause in every subcontract or purchase order of \$2,500 or more unless exempted by rules, regulations, or orders of the Secretary of Labor issued pursuant to section 503 of the Act, so that such provisions will be binding upon each subcontract or vendor. The contractor will take such action with respect to any subcontract or purchase order as the Director, Office of Federal Contract Compliance Programs, may direct to enforce such provisions, including action for noncompliance.

May 17, 1976

RFQ/IFB/PFP No. _____

Purchase Order/Contract No. _____

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

ADDITIONAL

CERTIFICATION

OF

STATUS AS A MINORITY BUSINESS ENTERPRISE

Offerors, bidders or suppliers are requested to COMPLETE, SIGN and ATTACH this page, in single copy, to any bid, proposal or quote submitted under the Solicitation identified above. Completion of this certification is not a condition of eligibility for contract award.

The Bidder/Offeree/Supplier certifies that he ☐ is, ☐ is not a minority business enterprise which is defined as a business, at least 50 percent of which is owned by minority group members or, in the case of publicly owned businesses, at least 51 percent of the stock of which is owned by minority group members. For the purposes of this definition, minority group members are Negroes, Spanish-speaking American persons, American-Orientals, American-Indians, American Eskimos, and American Aleuts.

Name and Title of Person Signing	Signature	Date

PRIVACY ACT NOTIFICATION

This procurement action requires the contractor to do one or more of the following: design, develop, or operate a system of records on individuals to accomplish an agency function in accordance with the Privacy Act of 1974, Public Law 93-579, December 31, 1974 (5 U.S.C. ,552a) and applicable agency regulations. Violation of the Act may involve the imposition of criminal penalties.

bona fide job order, including the assignment of referrals of veterans and nonveterans. The listing of employment openings does not require the listing of any particular job applicant or firm or particular group of job applicants, and nothing herein is intended to relieve the contractor from any responsibilities in Executive orders or regulations regarding nondiscrimination in employment.

(d) The reports required by paragraph (b) of this clause shall include, but not be limited to, periodic reports which shall be filed at least quarterly with the appropriate local office or where the contractor has more than one hiring location in a State, with the central office of that State employment service. Such reports shall include for each hiring location: (1) the number of individuals hired during the reporting period, (2) the number of nondisabled veterans of the Vietnam era hired, (3) the number of disabled veterans of the Vietnam era hired, and (4) the total number of disabled veterans hired. The reports should include covered veterans hired for on-the-job training under 38 U.S.C. 1707. The contractor shall submit a report within 30 days after the end of each reporting period wherein any performance is made in this contract identifying data for each hiring location. The contractor shall maintain at each hiring location copies of the reports submitted until the expiration of one year after final payment under the contract. During such time these reports and related documentation shall be made available upon request for examination by any authorized representatives of the contracting agency or of the Secretary of Labor. Documentation shall include personnel records respecting job openings, recruitment, and placement.

(e) Whenever the contractor becomes contractually bound to the listing provisions of this clause, it shall advise the employment service system in each State where it has establishments of the name and location of each hiring location in the State. As long as the contractor is contractually bound to these provisions and has so advised the State system there is no need to advise the State system of subsequent contracts. The contractor may advise the State system when it is no longer bound by this contract clause.

(f) This clause does not apply to the listing of employment openings which occur and are filled outside the 50 States, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands.

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

**DISABLED VETERANS AND
VETERANS OF THE VIETNAM ERA**

(a) The contractor will not discriminate against any employee or applicant for employment because he or she is a disabled veteran or veteran of the Vietnam era in regard to any position for which the employee or applicant for employment is qualified. The contractor agrees to take affirmative action to employ, advance in employment, and otherwise treat qualified disabled veterans and veterans of the Vietnam era without discrimination based upon their disability or veterans status in all employment practices such as the following: employment upgrading, demotion or transfer, recruitment, advertising, layoff or termination, rates of pay or other forms of compensation, and selection for training, including apprenticeship.

(b) The contractor agrees that all suitable employment openings of the contractor which exist at the time of the execution of this contract and those which occur during the performance of this contract, including those not generated by this contract and including those occurring at an establishment of the contractor other than the one wherein the contract is being performed but excluding those of independently operated corporate affiliates, shall be listed at an appropriate local office of the State employment service system wherein the opening occurs. The contractor further agrees to provide such reports to such local office regarding employment openings and hires as may be required.

State and local government agencies holding Federal contracts of \$10,000 or more shall also list all their suitable openings with the appropriate office of the State employment service, but are not required to provide those reports set forth in paragraphs (d) and (e).

(c) Listing of employment openings with the employment service system pursuant to this clause shall be made at least concurrently with the use of any other recruitment source or effort and shall involve the normal obligations which attach to the placing of a

bona fide job order, including the acceptance of referrals of veterans and nonveterans. The listing of employment openings does not require the hiring of any particular job applicant or from any particular group of job applicants, and nothing herein is intended to relieve the contractor from any requirements in Executive orders or regulations regarding nondiscrimination in employment.

(d) The reports required by paragraph (b) of this clause shall include, but not be limited to, periodic reports which shall be filed at least quarterly with the appropriate local office or, where the contractor has more than one hiring location in a State with the central office of that State employment service. Such reports shall indicate for each hiring location (1) the number of individuals hired during the reporting period, (2) the number of nondisabled veterans of the Vietnam era hired, (3) the number of disabled veterans of the Vietnam era hired, and (4) the total number of disabled veterans hired. The reports should include covered veterans hired for on-the-job training under 38 U.S.C. 1787. The contractor shall submit a report within 30 days after the end of each reporting period wherein any performance is made on this contract identifying data for each hiring location. The contractor shall maintain at each hiring location copies of the reports submitted until the expiration of one year after final payment under the contract during which time these reports and related documentation shall be made available upon request for examination by any authorized representatives of the contracting officer or of the Secretary of Labor. Documentation would include personnel records respecting job openings, recruitment and placement.

(e) Whenever the contractor becomes contractually bound to the listing provisions of this clause it shall advise the employment service system in each State where it has establishments of the name and location of each hiring location in the State. As long as the contractor is contractually bound to these provisions and has so advised the State system, there is no need to advise the State system of subsequent contracts. The contractor may advise the State system when it is no longer bound by this contract clause.

(f) This clause does not apply to the listing of employment openings which occur and are filled outside the 50 States, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands.

(g) The provisions of paragraphs (b), (c), (d), and (e) of this clause do not apply to openings which the contractor proposes to fill from within his own organization or to fill pursuant to a customary and traditional employer-union hiring arrangement. This exclusion does not apply to a particular opening once an employer decides to consider applicants outside of his own organization or employer-union arrangement for that opening.

(h) As used in this clause: (1) "All suitable employment openings" includes, but is not limited to, openings which occur in the following job categories: production and non-production; plant and office; laborers and mechanics; supervisory and nonsupervisory; technical; and executive, administrative, and professional openings that are compensated on a salary basis of less than \$25,000 per year. This term includes full-time employment, temporary employment of more than 3 days' duration, and part-time employment. It does not include openings which the contractor proposes to fill from within his own organization or to fill pursuant to a customary and traditional employer-union hiring arrangement nor openings in an educational institution which are restricted to students of that institution. Under the most compelling circumstances an employment opening may not be suitable for listing, including such situations where the needs of the Government cannot reasonably be otherwise supplied, where listing would be contrary to national security, or where the requirement of listing would otherwise not be for the best interest of the Government.

(2) "Appropriate office of the State employment service system" means the local office of the Federal/State national system of public employment offices with assigned responsibility for serving the area where the employment opening is to be filled, including the District of Columbia, Guam, Puerto Rico, and the Virgin Islands.

(3) "Openings which the contractor proposes to fill from within his own organization" means employment openings for which no consideration will be given to persons outside the contractor's organization (including any affiliates, subsidiaries, and the parent companies) and includes any openings which the contractor proposes to fill from regularly established "recall" lists.

(4) "Openings which the contractor proposes to fill pursuant to a customary and traditional employer-union hiring arrangement" means employment openings which the contractor proposes to fill from union halls,

which is part of the customary and traditional hiring relationship which exists between the contractor and representatives of his employees.

(i) The contractor agrees to comply with the rules, regulations, and relevant orders of the Secretary of Labor issued pursuant to the Act.

(j) In the event of the contractor's noncompliance with the requirements of this clause, actions for noncompliance may be taken in accordance with the rules, regulations, and relevant orders of the Secretary of Labor issued pursuant to the Act.

(k) The contractor agrees to post in conspicuous places available to employees and applicants for employment notices in a form to be prescribed by the Director, provided by or through the contracting officer. Such notice shall state the contractor's obligation under the law to take affirmative action to employ and advance in employment qualified disabled veterans and veterans of the Vietnam era for employment, and the rights of applicants and employees.

(l) The contractor will notify each labor union or representative of workers with which it has a collective bargaining agreement or other contract understanding that the contractor is bound by terms of the Vietnam Era Veteran's Readjustment Assistance Act and is committed to take affirmative action to employ and advance in employment qualified disabled veterans and veterans of the Vietnam era.

(m) The contractor will include the provisions of this clause in every subcontract or purchase order of \$10,000 or more unless exempted by rules, regulations, or orders of the Secretary issued pursuant to the Act, so that such provisions will be binding upon each subcontractor or vendor. The contractor will take such action with respect to any subcontract or purchase order as the Director of the Office of Federal Contract Compliance Programs may direct to enforce such provisions, including action for noncompliance.

SUPPLEMENT TO PROPOSAL

CERTIFICATE OF CURRENT COST OR PRICING DATA

This is to certify that to the best of my knowledge and belief, cost or pricing data* submitted in writing, or specifically identified in writing if actual submission of the data is impracticable (see 1-3.807-3(h)(2)), to the Contracting Officer or his representative in support of

_____* are accurate, complete, and current as of
_____*
_____*

(date)

FIRM _____

NAME _____

TITLE _____

(Date of execution)

*For definition of "cost or pricing data," see FPR 1-3.807-3.

**Describe the proposal, quotation, request for price adjustments, or other submission involved, giving appropriate identifying number (e.g., RFP No. ____).

***This date shall be the date when the price negotiations were concluded and the contract price was agreed to. The responsibility of the Contractor is not limited by the personal knowledge of the Contractor's negotiator if the Contractor had information reasonably available (see 1-3.807-5 (a)) at the time of agreement, showing that the negotiated price is not based on accurate, complete, and current data.

****This date should be as close as practicable to the date when the price negotiations were concluded and the contract price was agreed upon.

Senator BROOKE. Now your testimony reveals a major weakness in the State guarantee system which I really don't think has been discussed before. That is, the treatment of a policyholder's surplus lines, insurers doing business in States in which they are not licensed.

For our benefit, could you give the committee a concrete example of how the out-of-State claimant of a surplus lines insurer could be deprived of any protection against solvency?

Mr. HUNTER. I think it was in the full statement. I will turn to Mr. Clark on that.

Mr. CLARK. Senator, the NAIC model act defines an insolvent insurer as an insurer licensed in the State.

Now if the insurer is acting in a particular State only as a surplus lines insurer, it is obviously not a licensed insurer, therefore the Solvency Guarantee Act in that State does not apply.

When you get to the State of the surplus line insurer's domicile, then the act defines a covered claim as a claim of a policyholder or claimant resident in that State at the time of the event.

So it thus follows that the insured, or the claimants in a foreign state, a seriously injured products liability claimant, for example, would receive no benefit from any Solvency Guarantee Act. And we are terribly concerned about that.

Senator BROOKE. Now have the products liability and medical malpractice crises increased the business of surplus lines companies?

Mr. CLARK. Very tremendously, because I noticed some figures recently in connection with the products liability insurance problem, where there has been a tremendous increase in surplus lines activity.

I hasten to say, Senator, there are a lot of surplus lines insurers who are running mates of larger insurers, and I am not suggesting there is any widespread insolvency concern about those insurers. But the fact of the matter is this is the type of situation which beckons somebody to come into a market that is very fertile for gathering a large volume of premiums in a hurry.

There was an insurer that recently was declared insolvent, that did have—we made some calculations indicating that perhaps over half of its business was written on surplus lines basis.

Senator BROOKE. How do these surplus lines companies operate in the reinsurance market?

Mr. CLARK. It is hard to say. Probably some of them operate and provide some facultative reinsurance and particularly in the products liability line.

Senator BROOKE. I am sorry?

Mr. CLARK. I say there are probably some surplus lines insurers that are affording a good bit of reinsurance on a facultative basis. That means a specific risk basis.

Senator BROOKE. That example you had reference to, was that the Allstate Insurance Co.?

Mr. CLARK. No, sir, not Allstate by any means. All Star.

Senator BROOKE. All Star, rather. There is a difference.

Mr. CLARK. Yes; some are in considerably better hands with one than the other.

Senator BROOKE. Could you give us a description of what happened in that case?

MR. CLARK. Well, this, of course, is a situation in which the State of domicile will obviously administer the estate of the insolvent insurer. Presumably there are some other States in which that insurer was licensed and those States presumably also participate in the liquidation of the insurer through ancillary liquidators.

I just do not know, Senator, how many claimants there are though in States in which that insurer was not licensed who are simply going to obtain no benefit from any guarantee mechanism.

Senator BROOKE. Thank you very much.

Now, Mr. Hunter, in your opinion the preemption of forms approval under the Federal chartering provisions of the bill would help to eliminate what you characterize as a myriad of potentials for overlapping, duplication of effort, expense, and jurisdictional conflicts.

You also state a myriad of matters need to be very carefully sorted out in the study of the bill.

I am not suggesting you give us the whole myriad here, but would you outline a few more of the problems which you feel are deserving of further study?

Mr. HUNTER. Well, the basic ones, again not as respects the insolvency section, because that section doesn't trouble me as much as the dual chartering section, the most important one to us is the allowance of untrampled selection competition, which we think would result in an exacerbation of problems rather than a better market, based upon our review of lack of success in unregulated places like California, where we see 1 out of 3, approximately, motorists are underserved, either uninsured in an assigned risk plan or in a substandard market.

Our review of the FAIR plan in Illinois shows it grew 60 percent since Illinois rate regulation was taken off, whereas countrywide it grew only 25 percent.

These kind of indicators make us worry about what will happen to people if the bill doesn't address specifically the issue of availability of insurance somehow.

There are many parts of regulation that are intertwined. For example, forms that you and I mentioned.

The forms must be tied into who controls the rate, because they are so closely intertwined.

If a State can control the forms, and there is no rate regulation, there is in effect rate regulation, because in health insurance, for example, where there has been no rate regulation in many States, there really has been rate regulation through disapproval of forms, by saying this form does not comport with our need for the form being adequate relative to the rate. In other words, they disapprove the form based upon the rate or something of that nature.

So in effect there is an indirect rate regulation in health insurance.

These sorts of things I think are the type of things that need to be addressed carefully.

Another question that I didn't address in my statement would be what happens if a federally chartered insurer, say, were the only insurer in a large jurisdiction that was writing malpractice, or property insurance—malpractice is a better example, because there were certainly cases where the entire State was essentially covered by one insurer. Could that insurer be totally free to set its own rates? It is a *real issue*. Obviously there is no competition. Most States, even the

open competition States, have a way of reimposing rate regulation if and when there is a clearly demonstrated case of no competition. Those are the sorts of things we worry about.

Senator BROOKE. Thank you. Now you mentioned the possibility that the existence of both Federal and State regulators could lead to competition which would work against the consumers' interest. This legislation, of course, leaves to the States the sole responsibility for enforcement of consumer protection statutes, both for federally and State chartered companies, as you know.

Doesn't this seem to preclude competition among regulators to the detriment of the consumer?

Mr. HUNTER. I don't believe so. I believe that in order to try to attract major companies into your regulatory sphere, you might find ways to soften regulation in order to in effect increase your own authority by getting the big companies to join your game and leave the other fellow's game.

Senator BROOKE. Finally, Mr. Hunter, I sort of detected some differences between your view of open competition and that which is presented in the Justice Department's testimony, which we have already heard and which you listened to.

Would you care to comment on the Justice Department's study?

Mr. HUNTER. I agree we have a difference. I believe the Justice Department study recognizes the fact we have a major difference on the issue of competition in insurance. We believe insurance is totally different than a manufacturer of air-conditioners, something of that nature, where competition, it seems to me, always works to the benefit of the consumer in terms of price.

One of the best ways to maximize your profits in insurance is to deny insurance to good, clean risks, even by your own definition, based upon your subjective analysis. We have files replete with examples of individuals who were inspected and who had perfectly fine homes but who were denied because they are in a zip code an insurance company has chosen not to write in. And I don't believe exacerbation of that practice would be beneficial.

As I point out, the FAIR plan in Illinois grew faster than the countrywide average after Illinois rate regulation was eliminated.

I am very concerned about that type of effect. I believe we have a legitimate and honest difference of opinion on that issue.

Senator BROOKE. Thank you. My 10 minutes have expired. I will ask you questions, Mr. Sims, when it is my turn again.

The CHAIRMAN. Senator Sparkman?

Senator SPARKMAN. Mr. Chairman, I shall be very brief, well within the 10 minutes.

Now all of this is in connection with consideration of S. 1710. Did I understand you, Mr. Hunter, to say that you are not ready to accept all of the terms of S. 1710, that you had to give it further thought?

Mr. HUNTER. My testimony, sir, was that we believe it is a wonderful discussion piece for the question, serious public policy question of regulation of insurance which needs addressing very much. But we are not ready at this time to say yes to any specific approach. We believe it is premature at this point.

Senator SPARKMAN. Is that true with you gentlemen, too?

Mr. SIMS. We certainly agree that the bill provides a discussion platform which hopefully will enable the Congress to resolve some of these difficult policy questions.

I think, as with the Federal Insurance Administration, the Department is not yet ready to take a position yea or nay on a specific legislative proposal at this time.

Senator SPARKMAN. Well, is the Government in position to help work out legislation? In other words, if you subscribe to the objective of S. 1710, can there be a way in which suitable provisions can be worked out?

Mr. HUNTER. I don't think there is any question from our point of view that there is room for improvement, obviously, in any system.

Senator SPARKMAN. And you could use S. 1710 as the agency for doing that?

Mr. HUNTER. I don't—I believe it is a discussion piece.

Senator SPARKMAN. I realize you think it needs more discussion.

Mr. HUNTER. I believe the Federal Government legitimately has a role in insuring the regulation of insurance is improved. But whether it is done through a dual regulatory system, or through a solely State-regulated system, or a State-regulated system with some help from the Federal Government, or a Federal regulatory system, I think are questions that need resolving, but there is no question regulation can be improved.

Senator SPARKMAN. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. I would like to ask you a question along that line.

You say in your opening statement that the Federal guarantee program may further weaken the State guarantee funds by selecting out the stronger companies which meet Federal standards, it would come out from under the regulation and therefore the funds would be weakened.

Then you go on to say, and I quote: "Thought may need to be given to the desirability of preemption," a power which Chairman Williams of the SEC seemed to flatly reject, at least he thought it was unattractive.

Are you saying that the Federal Government should assume sole jurisdiction over granting policyholders, or I should say guarding policyholders against insurance company insolvencies? The States are incapable of offering that protection?

Mr. HUNTER. No; that is not quite what I am saying. What I am saying is given the contents of the bill we are discussing, if that bill were moving toward law, I would think that serious consideration should be given to preemption on the basis that the State insolvency programs would be so weakened by selection-out into the Federal approach that they would perhaps not be capable of offering the kinds of protection at that point that would be needed.

Now Senator Brooke is quite right, there is a lot wrong with the State guarantee funds today. They need strengthening.

The CHAIRMAN. Are you arguing against proceeding with the bill, unless we provide for some kind of pre-emption?

Mr. HUNTER. No, I am not. I am not arguing against moving forward in consideration of this bill, because I think at least it offers—just the consideration of it—offers the atmosphere in which States may find themselves in a better position to strengthen their approaches.

I would hope that you would continue to consider this bill.

Senator BROOKE. Would you yield at that point, if I may?

The CHAIRMAN. Yes.

Senator BROOKE. If larger companies were to leave the State guarantee funds system—and I am not saying that they would, that is open to debate—that would no doubt reduce the size of the pool on which the State guarantee funds could draw to pay for an insolvency. But of course with the withdrawal of these large companies, if it occurred, it would also reduce the exposure of the State guarantee fund at that point, I think, has not been made.

The CHAIRMAN. What I am concerned about, of course, is you might have stronger companies, whose policies might be sounder, opting to get under the Federal jurisdiction, and leaving the weaker companies with less resources and greater risks possibly for the State to try to protect with inadequate funds.

Mr. HUNTER. That is what I meant by the expression "adverse selection." It wouldn't be a one-to-one transfer. I am afraid the stronger companies would transfer out and in an absolute sense the State pool's strength would be lowered, but I don't believe it would be one-to-one.

Senator BROOKE. I don't think we know that.

Mr. HUNTER. No.

The CHAIRMAN. Mr. Sims.

Mr. SIMS. I certainly don't know the answer to your question.

The CHAIRMAN. How do you stand on the preemption issue?

Mr. SIMS. I don't think, at least based on what we know, there is a case for preemption at this point. There is the possibility of what the Federal Insurance Administration fears could happen.

On the other hand, to the extent that we have an analogous situation in the banking field, that has not proven to be a serious problem in that field. So I don't think at this stage of the game we can really make a precise determination as to what will happen in the event of a dual chartering system.

The CHAIRMAN. Thank you. Senator Brooke.

Senator BROOKE. Mr. Sims, I want to thank you for your very fine summary of the study done by the Justice Department on the pricing and marketing of insurance, and we are very privileged to have the principal author of that study here with us.

Mr. Sims, you state, and I quote:

The long-run experience of at least one major insurance state that had an open competition system, in which the state has relied on market forces to control prices, suggests that unrestricted price competition can provide a most effective substitute for rate regulation, reasonable prices, maximum efficiency in the sale and distribution of insurance.

I take it that the State you are referring to is California, is that correct?

Mr. SIMS. That is correct.

Senator BROOKE. Is it not true that even in California where open competition exists, the State regulators still retain the authority to set aside rates which are unfairly discriminatory?

Mr. SIMS. That is correct.

Senator BROOKE. Does such authority go beyond preventing discrimination on the basis of race, sex, or religion?

Mr. SIMS. Yes.

Senator BROOKE. How far does it go?

Mr. SIMS. My understanding, and Mr. Maseritz can correct me if I am wrong, is that the regulatory authority in California extends to the common kind of rate regulation language. I don't know what the precise language is.

Mr. MASERITZ. The language is essentially that rates can not be excessive, inadequate, or unfairly discriminatory.

Senator BROOKE. Mr. Sims, Mr. Hunter, in his statement—we have discussed this to some extent—mentions the problem of selection competition, the ability of an insurer to effect success not by price or quality of his product, but by selecting its customers in a fashion that will give it an advantage over its rival.

Selection competition is a feature of the insurance economy which seems to provide a ground for distinguishing insurance from other products and services, and for fashioning for insurance a series of specific rules, unique to its problems and circumstances.

How does the Justice Department study deal with the problems of selection competition?

Mr. SIMS. First of all, I think to the extent that we understand what selection competition is, it appears to us to be as much a product of the regulatory system as it is of the nature of the product or service sold.

In an unfettered marketplace, you would anticipate that there would be competition for the better risks, to use the insurance term. But you would also expect that the less than superior risks would be served at a higher price commensurate with the difference in the anticipated risk.

In the insurance industry today there are severe restraints upon the pricing of the insurance product for those high risk customers. And where you have restraints on maximum pricing for the fellow who has an automobile accident once a month, you are undoubtedly going to have companies seeking to get away from that kind of fellow, and getting into the marketplace with preferred risks, which never have automobile accidents.

It doesn't follow from that experience in a highly regulated system, that you would have the same kind of problem in a relatively unregulated system.

Indeed, I would expect that problem would not be of the same magnitude. True, in an unregulated system, the guy who has an accident once a month is going to have to pay a real high premium for his automobile insurance. If that is seen to be a problem, the preferred way from our perspective to deal with that would be through a direct subsidy, some kind of direct payment to the individual, rather than the cross-subsidy which exists today by raising rates generally in order to pay for the increased loss experience that companies face with that type of individual.

Senator BROOKE. Thank you. Now you advocate early detection and swift removal of failing insurers, rather than keeping every insurer afloat.

Is that approach taken in those States in which open competition now exists?

Mr. SIMS. I just don't know the answer to that question. There have been recommendations of various kinds, I think in New York, if I am

correct, that that approach should be utilized. But to my knowledge that recommendation has never been fully implemented.

Senator BROOKE. You don't know in how many States?

Mr. SIMS. No; I simply don't know the answer to that. It is the system, by and large, which works in the banking field, administered by the Federal bank regulators, and works, based on our experience, very well.

Senator BROOKE. Now you state that the Justice Department's report did not examine in depth the potential impact of unrestricted price competition on smaller insurers.

Do you know if smaller insurers in California have been adversely affected by the existence of open competition?

Mr. SIMS. Based on our information, the answer is no. I think there was a report by the California Insurance Department, which indicated there had not been a particularly abnormal exit rate for small insurers based on their experience in the open competition system.

There is always a problem when you face a move from a regulated system to an unregulated system. There are always fears and concerns of the unknown, no matter how attractive some of its features may be; it is always the unknown. You know what you are living with today.

Senator BROOKE. It is the devil you know rather than the devil you don't know.

Mr. SIMS. That is right. You see that in the airline industry today, in various other industries, in which there is some talk about lessening regulation. That uncertainty would be with us in the insurance field as well.

But there is no reason, based on our knowledge, to believe efficient small insurers wouldn't be able to survive quite well in an unregulated environment.

Senator BROOKE. You have stated that it is important to permit regulation of rates by the States in cases where reverse competition exists. That is, where insurers compete for the agent's business rather than directly for the business of the ultimate consumer. Has State regulation been effective in protecting consumers in the case of credit life and health insurance or in the case of title insurance?

Mr. SIMS. That is another question I simply don't know the answer to. I think the reverse competition problem needs more study, and more data needs to be collected.

I don't think, based on what we know right now, we can really say whether or not State regulation has worked.

Senator BROOKE. Would you elaborate briefly on your statement that the life insurance industry generally may be subject to reverse competition?

Mr. SIMS. I would like Mr. Maseritz to respond to that.

Mr. MASERITZ. Could you ask the question again, Senator?

Senator BROOKE. Would you elaborate on your statement that the life insurance industry generally may be subject to reverse competition?

Mr. MASERITZ. The question arises because of the existence of the so-called expense limitation laws in three States, including New York. New York has indicated in various studies that there is need to control the expenses of agents because, in the case of whole life insurance, it

is a product that is sold, that is to say, it is a product in which the company has to go out to the consumer and make a case for the service in many instances.

Insurance companies want to provide an inducement to their agents and they do this through commissions.

Now at the same time there is the problem in life insurance of consumer information and consumer knowledge, because it is a highly complex service and product. It is this combination of factors—the incentive to sell and lack of information—that results in competition for the agents as opposed to competition for the ultimate consumer. We believe that is the basis for the expense limitation laws and the need to regulate the expense element of the premium.

Senator BROOKE. Thank you. I have one final question.

The CHAIRMAN. I believe Mr. Clark wanted to comment.

Senator BROOKE. I am sorry, yes, Mr. Clark.

Mr. CLARK. Senator, you have this problem: If the commission rate for the life insurers is 95 percent of the first annual premium for whole life, and the commission rate for term life is 35 percent, the chances are that there is going to be an awful lot of whole life sold and very little term life, even though the needs of many many people may be for term life. That is the concern.

Senator BROOKE. Thank you very much, Mr. Clark.

Now, Mr. Sims, one of the witnesses who will appear later in the week will state that S. 1710 works against the interests of smaller insurance companies, because, and I quote:

A host of opportunities will exist for Federally chartered insurers to exploit market and pricing opportunities and out-maneuver their State chartered competitors at every turn.

Would you care to comment on that?

Mr. SIMS. That sounds like competition. You know, the great benefit of a competitive marketplace is that it forces people through a system of inexorable rewards and penalties to do their best. And doing their best means thinking about how they can beat the competition and provide a better service at a lower price, if possible.

That is not a concern that would particularly bother me.

Senator BROOKE. Thank you. Mr. Chairman, I want to again commend the panel, it has been an excellent panel, and very helpful. I am very grateful to each of you.

Again, Mr. Chairman, I thank you.

The CHAIRMAN. I agree, I think it has been a fine panel. All four of you gentlemen have been very helpful.

Here is one of the brightest, sunniest days of the year today, and we have pulled the shades to keep us from being flooded with too much light, yet we turn on the artificial lights, and we determined from an expert on the subject that we use about a gallon of oil by keeping these lights on all day.

It seems to me we could make one concrete specific contribution to energy conservation, probably the best the Congress will make all year, by turning the lights off when the sun is shining. From now on we will do that.

The committee will reconvene tomorrow morning at 9:30 to hear six experts on this subject.

[Thereupon, at 12 noon the hearing was recessed, to reconvene at 9:30 a.m. the following day.]

FEDERAL INSURANCE ACT OF 1977

TUESDAY, SEPTEMBER 13, 1977

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m., in room 5302, Dirksen Senate Office Building, Senator William Proxmire, chairman of the committee, presiding.

Present: Senators Proxmire, Brooke, and Schmitt.

Senator BROOKE. The committee will come to order.

Chairman Proxmire will attend very shortly. He is unavoidably delayed but we will proceed with the testimony because we have many witnesses and much testimony this morning. The first panel will consist of the National Association of Insurance Commissioners, Mr. Wesley Kinder, insurance commissioner of the State of California; and from the Commonwealth of Massachusetts, James Stone, the insurance commissioner; and from the State of Illinois, Richard L. Mathias, director of insurance.

Will you come forward and, Deputy Commissioner Rodney, would you come forward with Mr. Stone. Director Mathias, will you identify your colleague?

Mr. MATHIAS. Senator Brooke, accompanying me on the right is Michael Hasten, who's our chief counsel.

Senator BROOKE. Welcome. We are pleased to have you.

Commissioner Kinder and Director Mathias, I don't have a résumé on you, but being from Massachusetts I am pleased to introduce Commissioner Stone.

I am particularly pleased to have you, Commissioner Stone. Mr. Stone is a graduate of Harvard College where he received a B.A. degree in 1969 with highest honors in economics. He also holds a Ph. D. in economics from Harvard and has served on the Harvard faculty.

From 1971 to 1975, Mr. Stone worked at Fairfield & Ellis, a prominent Boston-based insurance brokerage firm, and he served as vice president of that firm.

He has a number of publications to his credit, including a book titled "One Way for Wall Street."

He was appointed commissioner of insurance by Governor Dukakis on February 28, 1975.

Commissioner Stone is accompanied by Deputy Commissioner Keith Rodney, who has quite a record in his own right. He is a graduate of Syracuse University with a major in accounting and a concentration in economics. He is a certified public accountant, and before accepting

his present position he served as an audit manager with the accounting firm of Coopers & Lybrand, specializing in insurance.

At the insurance division he has responsibility for the licensing of companies and agents. And, of particular importance for our record, he oversees examinations and investigations of all licensees and handles all matters dealing with insolvencies.

As I said, we are very, very pleased also to have Commissioner Kinder and Director Mathias.

Gentlemen, I want to thank you for submitting your statements. I want you to know that we appreciate the time and effort that you put into those statements, and you may proceed with them. If you wish to abbreviate them, that would be appreciated by the committee. The full text of your statements, of course, will be printed in the record, and we do have many questions that we want to ask of you. So you may proceed and, Commissioner Kinder, would you lead off?

**STATEMENT OF WESLEY J. KINDER, INSURANCE COMMISSIONER,
STATE OF CALIFORNIA, REPRESENTING THE NATIONAL ASSO-
CIATION OF INSURANCE COMMISSIONERS**

Mr. KINDER. Thank you, Senator.

My name is Wesley J. Kinder. I'm commissioner of insurance in the State of California and member of the executive committee of the National Association of Insurance Commissioners, commonly referred to as the NAIC. Having its inception in 1871, the NAIC is the oldest voluntary association of State officials. The NAIC membership consists of the principal insurance regulatory officials in the 50 States, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands.

Senator, you have a written statement on our behalf and rather than repeat it in its entirety I will excerpt from it here.

Senator BROOKE. We're very grateful.

[Complete statement of Mr. Kinder follows:]

STATEMENT OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

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IV. Summary.

Mr. Chairman and members of the Banking Committee, my name is Wesley J. Kinder, Commissioner of Insurance in the State of California and member of the Executive Committee of the National Association of Insurance Commissioners (commonly referred to as the NAIC). Having its inception in 1871, the NAIC is the oldest voluntary association of state officials. The NAIC membership consists of the principal insurance regulatory officials in the 50 states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands.

I. INTRODUCTION

The NAIC appreciates the opportunity to testify before this committee during your initial consideration of the "Federal Insurance Act of 1977." Generally, the basic issue posed by S. 1710 is couched in the terms of state versus federal regulation. However, the ultimate issue, implicit in the longstanding controversy surrounding state vs. federal regulation is now and has always been what kind of insurance regulation will best serve the interests of the public. We trust that the public interest will remain clearly in your view throughout these proceedings. We also trust that your ultimate conclusion will once again reaffirm the current desirability and historical effectiveness of state insurance regulation. We believe that the predominant system of state insurance regulation should be maintained in the public interest. Hence, the NAIC strongly opposes the enactment of S. 1710.

The NAIC is deeply troubled by the general concept of alternative state and federal regulation of the insurance business contained in this bill. Although some problems do exist in the insurance business, like virtually all other industries, proposing a major shift to a federal regulatory system that either competes with or sits on top of the existing, well developed state system makes little economic sense in theory or as a practical matter. S. 1710 is posed as an alternative federal regulatory system, but it is unlikely that the existing, viable state insurance regulatory system would long continue in parity with the federal commission if this bill were enacted. Expansive development of such a federal agency will undoubtedly follow the enactment of S. 1710 either through conferral of additional powers by Congress, administrative assumption of authority, or both.

In an era characterized by promises of regulatory reform and reduction of overregulation, spawning yet another massive federal regulatory agency¹ is, at best, at odds with the times. In light of the fact that there has not been documented by any compelling need for federal regulatory involvement in the insurance business, such a shift would seem to be entirely superfluous and should, therefore, be suspect.

Nevertheless, we are acutely aware of the fact that we are engaged in an area of state regulation that exists at the sufferance of Congress. Even if not always comfortable, we welcome your probing efforts aimed at determining and maintaining the quality of state insurance regulation. S. 1710 is superficially an alternative scheme of federal regulation, but in its proper perspective, we hope that it emerges as a focus for partially carrying out your duty to oversee the performance of state insurance regulation rather than as the leading edge of its extinction.

Among our objections to S. 1710 are the following, briefly summarized concerns:

¹ At the recent American Bar Association National Institute in Minneapolis, a primary staff draftsman of S. 1710 estimated that the proposed federal agency would have a "few thousand employees."

(1) Congressional policy since 1945 with respect to insurance regulation has been expressed in the McCarran-Ferguson Act. The McCarran Act explicitly states that the policy of continuing state regulation is "in the public interest." S. 1710 carries with it the seed for substantially diminishing or eliminating state regulation. Enactment of this measure would, in effect, bypass the McCarran Act.

(2) The fair question against which state regulation should be evaluated is whether it is good and effective enough to prevail. No proper nor definitive demonstration has been developed to justify an alternative federal system of the scope envisioned by S. 1710. In short, there is no demonstrated need.

(3) The creation of a new, costly Federal commission charged with regulating the insurance business and operating a guaranty system far exceeds the purported need. The Federal Insurance Commission would certainly be contradictory to the prevailing notion of Federal deregulation and is virtually impossible to justify in terms of additional taxpayer expense or benefits.

(4) Enactment of S. 1710 may well have the effect of diminishing the incentives of States to continue developing measures to control insolvencies, jeopardize a constructive record of regulatory accomplishment, and generally disrupt ongoing State regulatory activities.

(5) The existing version of S. 1710 is seriously flawed both as to technical details and the conceptual viability of establishing alternative State-Federal systems.

(6) The analogy drawn with dual regulation in the banking industry is not appropriate nor does it justify Federal initiatives in insurance regulation.

(7) The ultimate consequences of Federal insurance regulation are unlikely to be in the best interests of the insurance consuming public.

The remainder of my remarks will elaborate on these and other concerns.

II. S. 1710 MEET NO DEMONSTRATED NEED

A. INSURANCE SOLVENCY CONCERNS

The major impetus in proposing S. 1710 apparently is the belief that either the states are incapable of effectively regulating the insurance business for solvency or, for whatever reason, they have not done so and are not about to. Senator Brooke acknowledged this in so many words upon introduction of S. 1710:

"The bill grew out of my concern about the financial condition of the property-casualty insurance business. In 1974 and 1975, property-casualty companies experienced the two worst years in their history, with combined underwriting losses totaling \$7 billion for the two years. . . . The weakened financial condition in the property-casualty industry and the possibility of a major company failure prompted me to consider what steps might be taken to insure protection for policyholders and improve the quality of regulation for solvency. . . . [T]he trauma of the last few years has brought home to me the need to improve the protections available to insurance policymakers before the next brush with disaster."²

The premise upon which S. 1710 is based is every bit as faulty as the proposed solution. The premise is faulty for at least two basic reasons. (1) The property-casualty insurance industry has experienced a difficult period in recent years—primarily because of severe inflation in the goods and services purchased with insurance benefits, diminishing investment returns and the general economic decline. However, the magnitude of the problem is relatively small, and the continuing profitability throughout this period (including 1974-75) as well as the return to profitability results consistent with the median results of the other U.S. industries collectively demonstrate that the idle speculation about potential disaster is grossly overstated. (2) The states have established and maintained both a sound mechanism for regulating the solvency of the insurance business and a sound record of protecting the insurance consuming public through (a) broad and detailed solvency controls and (b) guaranty fund protection in the event an insolvency occurs. Moreover, as will be discussed later and contrary to the intent of S. 1710, enactment of this bill would seriously jeopardize the financial solidity of the insurance industry and operate contrary to the interests of the insurance consuming public.

² 128 Congressional Record, S. 10085 (Daily Ed. June 16, 1977).

1. Magnitude of the alleged problem

The proponents of S. 1710 have blown the magnitude of the insolvency problem out of proportion and understated the ability of the industry to sustain insolvency assessments. In 1976, the NAIC Statistical Reporting System reported premiums of \$57.7 billion for all property and liability lines combined on a countrywide basis.^{*} At the same time, the National Committee on Insurance Guaranty Funds reports that in 1976, four property-casualty insurers were declared insolvent.[†] We estimate these insolvencies to result in assessments of less than \$21 million, or .036 of 1% of premiums. Overall operating income for 1976 totaled \$2.7 billion dollars. In other words, we estimate insolvencies in 1976 to cost less than .04 of 1% of premiums and less than 1% of net income. The alleged inability of an industry of this magnitude to sustain insolvency assessments through the existing guaranty funds established under state laws is obviously overstated.

Experience in the more difficult and recent years, 1974 and 1975, does not alter the underlying, obvious ability of the property-casualty insurance business to sustain assessments made under the state guaranty funds. During these two years, approximately 25 P/C insurers were declared insolvent.[‡] Meanwhile, the amount of assessments made under the state property-casualty guaranty fund laws have increased from \$49 million assessed prior to March 1975 to \$104 million since inception of the funds by January 1976, and \$121 million by January 1977.[§] Even with annual assessments at an extraordinarily high rate of \$60 million, such a figure would represent only .14 of 1% of premiums in 1974, .12 of 1% in 1975 and .1 of 1% in 1976. Although this information does not suggest the optimal form of a guaranty system, it does evidence the ability of the business to operate under the existing state system while at the same time providing the financial backstop needed to protect policyholders and claimants from insurance company insolvencies.

2. Profitability

Senator Brooke's views on underwriting losses as the basis of his solvency concerns also results in biased conclusions that are out of touch with real world profitability results of the insurance business. Underwriting results are not the bottom line for the insurance business in that they exclude investment gain, among other items. For the years 1971-1976, the NAIC Statistical Reporting System reports that property casualty insurers experienced the following industry-wide profitability results:

INDUSTRY PROFITABILITY ALL LINES COUNTRYWIDE PROPERTY AND LIABILITY INSURANCE

(In millions of dollars)

	Overall operating income	Total return	Mean net worth	Earned premiums (sales)
	(1)	(2)	(3)	(4)
1971.....	2,292	3,318	14,841	28,502
1972.....	3,060	4,858	21,136	37,558
1973.....	2,715	-226	21,786	40,322
1974.....	1,202	-4,663	21,696	42,100
1975.....	395	3,210	21,854	48,489
1976.....	2,685	4,821	24,196	57,653
Total.....	12,349	11,318	125,609	255,624

"Overall Operating Income" is total income excluding all capital gains and losses adjusted to generally accepted accounting principles, after federal taxes. "Total Return" equals "Overall Operating Income" plus all capital gains and losses (realized and unrealized) after federal taxes. In each of the years 1971-1976, insurers realized industrywide positive operating income. Expressed in terms of return on net worth, the results are as follows:

^{*} NAIC Report on Profitability By Line By State for the year 1977, Aug. 10, 1977. Guaranty Funds reports that in 1976, four property-casualty insurers were declared insolvent.[†] We estimate these insolvencies to result in assessments of

[†] National Committee on Insurance Guaranty Funds—Newsletter (hereinafter referred to as NCIGF Newsletter) vol. 6, No. 1, Jan. 26, 1977.

[‡] NCIGF Newsletter vol. 6 No. 2, Jan. 28, 1977 at 2.

[§] NCIGF Newsletter vol. 4 No. 2, Mar. 27, 1975 at 4; vol. 5 No. 1, Jan. 20, 1976 at 1; and vol. 6 No. 2 Jan. 26, 1977 at 1. These figures do not include insolvency assessments made under the New York preassessment guaranty fund law nor the New Jersey fund prior to 1974.

(In percent)

	Overall operating income on mean net worth (col. 1 + col. 3 above)	Total return on mean net worth (col. 2 + col. 3 above)
1971.....	15.4	22.4
1972.....	14.5	22.0
1973.....	12.5	-1.0
1974.....	5.5	-21.5
1975.....	1.0	14.6
1976.....	11.1	16.9
6-year average.....	8.8	8.9

The profitability results for the insurance industry for 1971-1976 compare quite closely with the median results for the 500 largest industrial corporations as compiled annually by Fortune Magazine.

The comparable 1971-1976 mean results reported by Fortune Magazine for return on net worth was 12.2 percent for the 50 largest commercial banking companies, 10.6 percent for the 50 largest utilities, and 5.5 percent for the 50 largest transportation companies. The banks and financial companies are similar to insurance in that they are financial industries, and utilities and transportation bear some resemblance in that their prices are regulated. The transportation industry, which is regulated primarily by federal agencies, is clearly in much worse financial condition than the insurance industry. A number of large transportation companies have failed under federal supervision in recent years. The inadequate financial strength of the transportation industry has been caused at least in part by the mass of federal regulatory controls and in turn has been the cause, at least in part, of the inadequate and declining service to the public by some forms of public transportation. We do not suggest that the insurance business has not had difficulties. From an availability standpoint, a 9 to 10 percent return on net worth is not sufficient to permit needed growth in net worth which is necessary to sustain growth in premium volume and the insurance needs of American consumers. Profitability results are notably improving and, as regulators, we intend to see that surpluses and reserves are brought up to levels that will strengthen financial condition and improve availability. However, the conclusion that the property-casualty business remains "deeply troubled" is at least overstated. Furthermore, and more importantly for your consideration of S. 1710, the alleged lack of adequate regulation for solvency and the suggested possibility of an insolvency disaster are patently false.

3. Regulation for solvency

In a free market, competitive environment, it must be expected that inefficient businesses will either do poorly or perhaps even fail. In the United States each year thousands of businesses fail, creating a loss of jobs and other adverse economic effects on those communities in which they are located. However, the average consumer is typically affected little by such failures and, overall, this purging effect may be beneficial to the economy.

In some industries, the impact of an insolvency may be more troublesome than the usual business failure. Dealing in the business of providing economic security, the insurance business has long been held to be affected with a special public interest.⁷ Insurers are therefore shielded to some extent from the full force of competition by way of capital and surplus, and other financial requirements aimed at assuring the performance of insurance obligations.

The public rightly regards the insurance business as a means to provide economic security upon the occurrence of the insured event, obviously requiring financially sound insurance companies. Nevertheless, insurance companies are poolers of risk. They use the law of large numbers to spread losses, and while they can reduce the chance of failure by pooling risks in sufficiently large numbers, they can never completely eliminate it.

Maintenance of the financial integrity of insurers and a method of assuring performance of insurers' obligations in the event of their insolvency are critical elements of the public's interest in effective regulation and operation of the insur-

⁷ *German Alliance Co. v. Lewis* 233 U.S. 680 (1914).

ance business. "[S]olvency requires (a) that premiums are sufficient to meet expected claims and expenses and (b) that assets are adequate to meet known liabilities, with an appropriate safety margin. Temporarily, large assets may balance out inadequate premiums, but long run solvency requires both adequate premiums and a contingency reserve or surplus to meet unexpected fluctuations."⁶

Protection of the insurance consuming public against insolvency is a primary concern and responsibility of the state insurance regulator.

The means used to meet these objectives have been developed through years of experience and are continuing to evolve and become more sophisticated. Primary among the insurance regulators tools to assure solvency are capital and surplus, premium to surplus requirements, investment restrictions, filing requirements for a broad scope of financial data, periodic examinations, conservative statutory accounting methods, asset valuation, reserve requirements, early warning tests, and rate regulation. A brief summary of some of these requirements and regulatory technique is instructive.

(a) Capital and Surplus

The purpose of requiring substantial initial capital and surplus is to provide an initial basis for financial viability so as to protect policyholders. If capital is impaired, the insurer is not allowed to continue operating. Paid-in surplus provides a working fund to pay expenses during the initial phase of activity of an insurer and to provide a cushion for unforeseen losses and expenses.

(b) NAIC Annual Statements

One of the most useful tools for monitoring company solvency is through the data provided on the uniform NAIC blank required by law and prescribed for all major segments of the industry. From this data submitted to the state authorities, the NAIC has implemented an early warning system to help state personnel promptly identify companies requiring close surveillance and determine the form such surveillance should take. In addition to the annual statement, many states require quarterly or semi-annual statements from companies believed to be experiencing financial difficulties.

(c) Valuation Procedures

Influenced by experience during the depression years and recently reinforced by the 1974 stock market decline, the NAIC has maintained procedures to "stabilize" the insurer's financial statement. Stocks and bonds held by insurers are valued in each company's annual statement according to rules established by the Valuation of Securities Subcommittee of the NAIC. High quality bonds are carried at amortized values rather than market reflecting the long term nature of insurance obligations.

Lower quality bonds and equities are carried at market values. However, the NAIC has, in periods of economic emergency such as the depression, used its valuation procedures to assure the continued solvency of insurers by authorizing the use of valuations at certain specified dates other than current market value. Without such stabilization procedures, excessive drain on company surpluses could have resulted from the temporarily depressed current market values. As long as insurance obligations can be met, wide transitory stock and bond market fluctuations should not per se force liquidation of securities at inopportune times. It might be noted in this context, that at the time during the great depression when banks were folding right and left and President Roosevelt was compelled to close the banks, the insurance industry was able to continue to function because of appropriate adjustments in the valuation rules by the NAIC.

(d) Monitoring Competition

Despite the general rule that insurers may use amortized values for high quality bonds, it is possible that in times of distress some insurers may be forced to liquidate such securities, resulting in heavy losses. For this reason, the NAIC has recently moved to enhance the regulatory monitoring of liquidity by adding to the financial reporting requirements a schedule of bond maturities and a cash flow statement. It is expected that these added disclosure requirements will materially assist the regulator in assuring that insurance companies maintain a proper, balanced mix of short, intermediate, and long term bonds, thereby enabling the insurance industry to better withstand the pressures of various economic climates.

⁶ Allen Meyerson, *Ensuring the Solvency of Property and Liability Insurance Companies; Insurance, Government and Social Policy* (1969) at 147.

(e) Early Warning System

The NAIC early warning system has been in operation for six years and has proved effective in flagging companies in financial difficulty. This system involves running a series of computerized financial tests on each company. Further efforts to improve the early warning system and promote its widespread, effective use are continuing. Regulatory scrutiny and the need for early examinations are suggested by the early warning system for particular insurers.

(f) Examinations

Every insurance company is subject to periodic examinations by the state insurance regulator. The ultimate purpose of surveillance is to protect against insolvencies and ensure fair treatment of policyholders and claimants. Examinations, either separately or in combination with other states, review both financial condition and market conduct. In 1976, the NAIC adopted a new modernized comprehensive handbook for examiners. This regulatory tool is subject to continuing review and improvement by a subcommittee of the NAIC. Major attention is now being focused upon improved training, upgrading and retaining competent examination personnel. The NAIC has adopted the concept of providing educational training for examiners and is currently working on the development, organization, and content of the program. Through these activities, the examination system has been undergoing a continuing review and strengthening process.

(g) Reserves

Reserve requirements are established by statutory state valuation standards for life insurers and by formula or percentage requirements for property-casualty companies by way of schedules in the annual statement blank. The NAIC constantly reviews these standards and schedules and updates them periodically to keep pace with current conditions.

(h) Investment requirements

The states, of course, control insurance company investments by statutory standards aimed at better assuring diversity, safety and liquidity and the ability of insurers to pay claims when due.

In contrast to specific statutory or regulatory detail involved in state regulation for these solvency tools, S. 1710 presents a bare bone skeleton of alternative federal insurance regulatory authority that may be adequate, overbearing, weak, and/or unworkable. Unfortunately, we are left to guess at the details.

Capital and surplus as well as reserve requirements are left to the Federal Commission to prescribe by regulation (secs. 202, 203 and 107). Examination and reporting requirements are similarly left to the commission to fill in. Rate regulation would be eliminated except for the judicial intervention of the antitrust division or the FTC. In short, S. 1710 suggests that the bulk of existing solvency controls be transferred to the discretion of a super powerful central regulatory bureaucracy that doesn't even currently exist.

In other words, S. 1710 is being sold as an alternative to state regulation, which is alleged to be inadequate, but the alternative apparently remains some kind of secret locked within the imagination of a nonexistent federal bureaucracy. We scarcely view S. 1710 as a responsible alternative to existing solvency controls in the states. In this light, S. 1710 can't even be intelligently discussed on the merits. But we can say, as demonstrated by this brief summary of state financial requirements and techniques, that state insurance regulation comprehensively and effectively addresses the problem of insurance industry solidity leaving no regulatory vacuum for federal redress.

4. Guaranty fund protection

Although insurance companies and the insurance regulators can minimize the risk of insolvency, the risk can never be entirely eliminated in the absence of regulatory burdens so onerous that the insurance mechanism could neither efficiently nor effectively function. It is very doubtful that a regulatory system which guarantees the continued solvency of every insurance company would contribute much other than higher tax or policy costs to the insurance consuming public. However, once an insurer reaches a point of severe financial difficulty due to adverse risk experience, bad management or other causes, it is essential that the insurance regulator have adequate authority to minimize the adverse consequences to the insurance consuming public. Consequently, in addition to regulating for solvency, the states are highly active in minimizing the adverse impact of

insolvencies when they do occur. Recent years have witnessed great strides in this area of enhancing public protection through the development of guaranty fund legislation.

A major premise of Senator Brooke's proposal, S. 1710, is apparently the perceived weakness of state insolvency proceedings and guaranty funds. It is our intention to correct this perception and highlight the firm resolve of the states to collectively address remaining interstate insolvency problems. Upon introduction of S. 1710, Senator Brooke noted that "obligations of insurance companies are protected by a system of state insurance guaranty funds," but he concluded that "most observers question their ability" to deliver the needed protections in the event of a major insolvency. We strongly disagree with this conclusion.

Since the late 1960's, the vast majority of states have moved to implement guaranty funds that, in effect, provide an insurance back up system for the benefit of consumers. Today, all but two states have guaranty fund laws for the property-casualty insurance business. At least 22 states have guaranty funds for the far less troublesome life and health insurance lines.⁹ Several factors—such as the long term nature of life contracts, predictable mortality risks, reinsurance and statutory reserves—minimize solvency problems in the life insurance business. Nevertheless, the NAIC has pushed for life and health guaranty fund laws for several years and adopted a model bill for this purpose in 1970. As noted earlier, the financial condition of the industry is adequate to bear the weight of insolvencies of the type that have occurred in recent years. During the period 1971-1976, property-casualty insurers had net operating income of more than \$12 billion, while insolvency assessments through the guaranty funds for insurers becoming insolvent over a somewhat longer period (November 1969-December 1976) were approximately \$121 million, or roughly one percent of net income. Related to premiums, the industry had aggregate earned premiums of \$255.6 billion during the period and the insolvency assessments represent .06 of 1% of premiums. The fact that the state guaranty funds are financially viable is evident.

Nevertheless, we recognize that the state system has not yet reached perfection. As part of current state efforts, the NAIC is moving toward a modernized model rehabilitation and liquidation law. It is expected that this model law will be finalized by December 1977. The model utilizes a three tiered approach to insurer financial problems. The first tier is supervision, which contemplates limited insurance department actions and the appointment of a supervisor when the state insurance department believes that an insurer's difficulties are readily correctable. Due process is assured to the insurer, and the state has access to the courts for necessary enforcement procedures. The second tier provides rehabilitation procedures in several situations including financial impairment of the insurer. Judicial action is necessary for rehabilitation. Finally, the model law provides for liquidation with judicial action again necessary. The model provides a definition of insolvency and provides the grounds under which the commissioner may petition for liquidation or rehabilitation. Adjudication of the financial condition of course guarantees due process to the insurer. The drafting task force of the NAIC has paid particular attention to assuring smooth interaction between the rehabilitator or liquidator and the various state guaranty funds.

The already existing property-casualty guaranty fund system is patterned after model legislation adopted by the NAIC in 1969. Under this legislation, the states require assessments against all admitted insurers writing the types of coverage written by the insolvent insurer based on a uniform percentage of net premium writings. Typically, the fund is administered through a statutorily created guaranty fund association of insurance companies under the direct supervision of the state insurance department. These funds guarantee the repayment of unearned premiums and payment of claims subject to deductibles and recovery limits. The NAIC model post assessment guaranty fund law provides a guaranty fund deductible of \$100 and a \$300,000 maximum recovery. These limitations provide substantial financial protection yet minimize the costs of providing the guarantees which, of course, are paid for by policyholders in any event.

⁹ 123 Congressional Record H10038.

¹⁰ Arizona, Connecticut, Idaho, Kansas, Maryland, Minnesota, Montana, Nebraska, Nevada, New Hampshire, New Mexico, New York, North Carolina, Oregon, Puerto Rico, South Carolina, Texas, Vermont, Virginia, Washington, West Virginia and Wisconsin.

Significant revisions to these guaranty fund laws have been made by a number of states in order to assure "early access" and "priority." In order to cut down on the assessments needed by the guaranty funds, at least 18 states now have "early access" provisions allowing the guaranty fund immediate access to any assets still held by the insolvent insurer for the purpose of paying claims assumed by the guaranty fund. In other words, upon an insolvency, assets of the defunct insurer can be used immediately to pay claims. When an insolvency occurs, only the deficit need be assessed to carriers participating in the guaranty fund. This substantially reduces the assessments and burden of the guaranty fund system. Without this provision, assets of the insolvent insurer are held in abeyance pending liquidation. "Early access" is provided by the new draft model liquidation law and is also expected to be acknowledged in an amendment to the model NAIO guaranty fund law. A number of knowledgeable experts have suggested that early access will improve the guaranty fund to the point where even jumbo or numerous smaller company insolvencies can be handled by the existing system without serious strain.

Another significant revision is the assurance of priority for guaranty fund claims in the insolvency or liquidation proceedings. The guaranty funds in this sense represent the consumer—claimants and policyholders—who should be entitled to priority over other general creditors. At least 16 states have already added such priority provisions to their guaranty funds laws, and this change is soon expected to be incorporated into the NAIC model bill.

Beyond these current changes to the existing guaranty fund system, the NAIO also has under review other suggestions which may or may not improve the method of guaranty fund operations such as a shift to a preassessment basis in which insurers would be required to set aside a specially earmarked guaranty fund reserve account, improved mechanisms for rescue of troubled companies in appropriate situations, etc.

It is clear that the states are continuing to improve and are prepared, where determined appropriate, to revise the procedures and mechanisms used to provide public protections in the event of insolvencies. State guaranty funds have already added an important dimension to the protection of financial security through insurance. Guaranty funds are in place and they work. Alternative measures and improvements are now being considered or implemented and this record of progress will continue. Historically as the insurance business has evolved, the states have responded with progressive regulatory development. This entire area of insolvency protections is no exception.

Coming on the heels of responsible state action in the 1970's in establishing the guaranty system, we view S. 1710 as an unnecessarily duplicative suggestion that would not operate in the public's best interest. State reforms are soundly based on real world experience gained from our day to day routine of regulating the insurance business. We respectfully suggest that the federal government's interest in regulating the insurance business be set aside until such time as it is demonstrated that the states have not and cannot provide responsible regulation and public protections. Most agree that 1974-1975 was one of the most difficult financial periods in recent history for insurers. The state insolvency system has proved its viability during this period despite speculative claims that it is now and has been unable to function adequately. We make no apologies and feel no embarrassment in standing before you on our existing record of regulation for solvency and providing insolvency protections.

B. NO NEED IS DEMONSTRATED BY THE IMPROPER ANALOGY TO THE BANK REGULATORY SYSTEM

Although federally chartered corporations are not unknown in the U.S.—e.g. banks—the addition of a new major industry to such federal regulatory control should be skeptically scrutinized. In his introductory remarks to S. 1710, Senator Brooke stated that the bill—

"Would seek to improve the quality of insurance company regulation by providing for an alternative system of federal regulation similar to the federal regulatory alternative presently available to banks and savings and loan associations."¹¹

Although our response to the quality of regulation point will be detailed later, I would like to comment now on the analogy drawn with the banking system. We

¹¹ 123 Congressional Record S10020.

emphatically disagree with the analogy insurance to banking and with the suggestion that dual regulation of banks in any way justifies or even parallels dual regulation of insurance.

The existence of continuing federal charter authority for banks did not come into being until 1863 after a "dismal record of state-chartered banks" in the early 1800's, poor and discontinued experience with the first two banks of the United States (1791-1811 and 1816-1836), and the pressures caused by the Civil War. The Civil War evidenced how unsuited the preexisting system was for financing of a major war effort.¹² The operation of the banking system is closely entwined with the the national power to create currency and regulate its value.

Without such demonstrated and compelling need for federal chartering and regulatory control, it is difficult to comprehend persuasive or reasonable motives for moving toward federal regulation of another major industry. It would certainly be a significant blow to the self-renewing vitality of federalism.

There is mention from time to time in some political crises of establishing a national chartering system for all industries—presumably to further centralize national economic control. Absent a showing of need, it is this anti-federalism motive which seems to stand out as a residual matter in S. 1710.

1. Perspective on banking analogy

It is a superficially attractive notion that regulation by the federal government would be more effective, less expensive, less burdensome, or more uniform. On the basis of experience, each of these propositions is of doubtful validity and they are positively not self evident. As to effectiveness of solvency controls, there is no sound basis for proper analogy or comparative analysis with the banking system.

Any statistical comparison of solvency data between insurers and banks or savings and loan institutions is empirically unsound. Historically, both the federal and state chartering authorities for banking institutions have contemplated the conferral of some degree of economic protection from competition—primarily to protect the security of deposits. "New entry into commercial banking is restricted in order to minimize the likelihood of failures."¹³

This philosophy plays little part in insurance regulation. Capital and surplus requirements for insurers and other financial controls are intended primarily to assure financial responsibility, not preclude entrance into the marketplace. Competition is largely absent from the "deposit" end of banking with which FDIC is concerned, while competition in the insurance business is expected to be vigorous.

The regulatory problems associated with financial examination and solvency determinations are more complex in the insurance business than in other financial institutions. For example, specific liabilities of property/casualty insurers for claims are routinely determined through negotiation or court verdicts, not on the basis of fixed dollar deposits, controlled interest rates, and known loan values.

Moreover, the federal record has not been demonstrably better than that of state insurance regulation in assuring the solvency of their financial institutions—e.g. banks, pensions—where the dual regulatory or predominantly federal systems flourish.

2. FDIC parallel

We have no intent to impugn the FDIC or any related regulatory operations of the federal banking system. We believe that the record of state insurance regulation for solvency is very good, although not perfect. Similarly, the record of FDIC lacks perfection but evidences a sound contribution to stability in the banking business and maintaining public confidence.

Senator Brooke, in proposing S. 1710, states that "the possibility of a major [insurance] company failure prompted me to consider what steps might be taken to insure protection for policyholders and to improve the quality of regulation for solvency."¹⁴ While we entirely disagree with the inference that an insurance company (or bank) failure necessarily means poor regulation, we do note that the 29 bank failures in the last two years exceed the 27 failures insurance experienced in the preceding five years.¹⁵ Furthermore, "the three largest failures in history occurred between 1971 and 1975."¹⁶

¹² Brown, "The Dual Banking System in the United States," pp. 8-12.

¹³ Brown at 5.

¹⁴ 123 Congressional Record 810038.

¹⁵ U.S. Comptroller General Highlights of a Study of Federal Supervision of State and National Banks, January 31, 1977 at 7.

¹⁶ *Id.* at 8.

Commenting on the experience with recent bank failures, the Comptroller General of the United States concludes that:

"It is apparent that the economy can tolerate the number of failures that have occurred in recent years, [but] we cannot determine at what point an intolerable situation would develop. For example, if the number of large bank failures were to increase, the economy could be seriously affected."¹⁷

Using both sides of the banking analogy coin and the styled arguments against state insurance regulation, it would seem that the dramatic rise in bank failures should suggest that some new measures may be needed to assure public protection from a continued increase in large bank failures.

Whatever its contribution to banking stability, the FDIC continues to be an expensive regulatory program. On December 31, 1975 the Federal Deposit Insurance Corporation held an accumulated fund of \$6.7 billion dollars, or 1.18% of the insured deposits at 14,714 covered banks.¹⁸ Net income to the fund was \$682 million in 1975,¹⁹ while loss reserves established for failed banks insured by FDIC over a five year period (January 1971 to June 30, 1976) total \$301 million.²⁰ In the entire history of FDIC since its inception in 1968, only \$227 million have been paid as deposit insurance losses and expenses.²¹ Meanwhile, the cost of federal bank supervision by FDIC alone was \$68 million in 1975. Bank supervision by the Federal Reserve and the Office of the Comptroller of the currency add another \$91 million in 1975.²² These sums notably do not include any detailed work on settling insurance claims in liquidation as apparently contemplated in S. 1710. An analysis of the costs and benefits of federal insurance regulation should certainly precede any affirmative action on S. 1710.

We do not suggest that the cost of operating FDIC is unreasonable or that the accumulated funds are unnecessary. We do suggest that the cost of operating FDIC can be expected to have a parallel in operating the Federal Insurance Commission and its Guaranty Fund in S. 1710 notwithstanding the fact that the states have acted responsibly in establishing methods to minimize the frequency of and to deal with insurance company insolvencies. State insurance guaranty funds are continuing to evolve, rendering the proposed new layer of federal guaranty involvement at best superfluous.

FDIC is fulfilling a valuable function for the benefit of the public. The expense of its proposed counterpart for insurance regulation, however, would be extremely difficult to justify because it would be overlaid on an existing state system. If an existing state system of bank deposit insurance were operating adequately, we suggest that the encroachment and expense of such additional federal protection would be entirely unjustified and contrary to the public interest. S. 1710 is for such reasons unnecessary and undesirable.

C. ABSENCE OF NEED TO APPLY THE FEDERAL ANTITRUST LAWS TO PROMOTE COMPETITION IN INSURANCE

S. 1710 proposes to remove state insurance rate regulatory authority and, in lieu of rate controls, apply the federal antitrust laws to federally chartered insurers. However, application of the antitrust laws to federally chartered insurers pursuant to Sec. 204 of S. 1710 will not significantly improve competition in the insurance industry. A major part of the insurance marketplace is the sale of life and health insurance. Rates for these lines, in some situations, are not regulated by the states. With respect to property and liability insurers, recent years have witnessed a trend toward open competition rating laws which now exist in about one third of the states. Many prior approval states are administered like open competition laws even in personal coverage lines like auto and homeowner insurance. Furthermore, the structure of the property and liability industry is inherently competitive in terms of concentration, number of companies, ease of entry and exit, etc.

Despite the existence of rating bureaus, insurance regulation is conducive to competition, in that both prior approval and open competition laws encourage competitive devices such as dividends by mutual companies, deviations from

¹⁷ *Id.* at 6.

¹⁸ Federal Supervision of State and National Banks, A Study by the Comptroller of the United States, January 31, 1977, at 1-14.

¹⁹ *Id.*

²⁰ *Id.* at 9-7 to 9-8.

²¹ 94th Cong. 2d sess., Audit of the FDIC, HD 94-586.

²² *Id.* at 1-14.

bureau rates, independent filings and product innovations. The combination of the Department of Justice, and the sanctioning of competition techniques by the rating laws has led to vigorous competition.

Competition for commercial business, which comprises approximately 50 percent of the property and liability business is particularly intense. The Justice Department readily admits that "insurers are generally free to set their own prices" ²⁰ on commercial risks. Combining this commercial business with existing open competition laws, as well as existing regulation of prior approval laws in the style of open competition, leads inevitably to the conclusion that the antitrust laws—even theoretically—could competitively influence only a small segment of the insurance markets—e.g. workmen's compensation, some residual markets and state made rates. Moreover, Sec. 204 of S. 1710 leaves rate regulation of residual markets to existing state law.

The insurance business underwriting performance and the comparatively nonexcessive profit performance indicates that competition is working. Economic analysis has indicated the existence of widespread competition. Consequently, the conclusion seems quite clear that the application of the federal antitrust laws to the property and liability insurance industry, through the enactment of S. 1710, would have minimal impact on enhancing competition in the insurance industry and, in addition (as will be noted below), may have unfortunate adverse consequences for the insurance consuming public.

III. ADVERSE IMPACT OF S. 1710 ON THE INSURANCE CONSUMING PUBLIC

Our comments have so far focused upon the absence of any demonstrated need for S. 1710 in light of its avowed, but faulty premises. There is no vacuum to be filled by federal insolvency regulation and the application of the antitrust laws would have at best minimal impact on increasing competition. In addition to the absence of need, however, S. 1710 should be rejected because of the adverse consequences which it poses for the insurance consuming public. Some of the adverse consequences that would flow from S. 1710 are highlighted below.

A. APPLICATION OF THE FEDERAL ANTITRUST LAWS WOULD ADVERSELY AFFECT THE PUBLIC INTEREST

1. *The States are better able to foster competition*

Presumably, the recommendation to oust state rate regulation and apply the federal antitrust laws in lieu thereof is premised on the belief that adequate competition can only be stimulated under the federal antitrust laws. This assumption not only fails to perceive the existing and extensive competition in the insurance business, but also overstates the "goodness" of "effectiveness" of the federal antitrust laws. The antitrust laws have been the subject of continuing criticism by economists and lawyers both as to various defects in substantive standards and ineffective enforcement. This point was recently reaffirmed during the 1977 American Bar Association meeting in Chicago during which the ABA's Antitrust Section considered the question, "Has Antitrust Promised Too Much and Delivered Too Little?" Thus, before even considering substituting the federal antitrust laws for a major segment of state insurance regulation, the defects of the antitrust laws should be carefully analyzed.

(a) *Substantive law*

In this statement, space does not permit a detailed analysis of the federal antitrust laws. Nevertheless, it should be noted that, although antitrust is founded on the concept of competition as a means to yield the optimum in allocation of economic resources, the legal aspects of antitrust often diverge from economic concepts. The legal and economic literature is replete with evidence that antitrust concepts, as currently applied, often make little economic sense, have little positive and perhaps sometimes a negative impact on competition, and/or are not worthwhile in terms of time and effort expended.

The Department of Justice, under the Sherman Act, is constricted to function within the ambit of court imposed definitions of the legal standards involving monopoly and restraint of trade. In contrast, state insurance regulators can apply the standards under the rating laws to better give effect to a result which makes more economic sense without, for example, having to find an implied

²⁰The Pricing and Marketing of Insurance, A Report of the U.S. Department of Justice, January 1977 at 341.

conspiracy in restraint of trade. The state open competition statutory standard for insurance on excessive rates is couched in terms of "competition" which is an economic concept unlike the more legalistic standard in the Sherman Act.²⁸ From the standpoint of the substantive standards, the state rating standards possess a greater potential to foster competition in the property and liability business than does the application of the federal antitrust laws.

Under the pure economic concept of competition, the marketplace is the sole regulator of prices. In sharp contrast, both the antitrust and the insurance laws contain substantial government enforcement mechanisms. Without attempting a long comparative review, we simply note that the states possess a wide array of enforcement tools to implement the open competition as well as other supporting insurance laws. To enforce compliance with the insurance laws, a wide variety of techniques have been employed including comprehensive financial statements, financial condition and market conduct examinations, civil and criminal penalties, injunctions, revocation of licenses to transact business, liquidation and rehabilitation proceedings, seizure, variety of commissioner orders including cease and desist, ratemaking authority, etc. In addition, in several of the open competition rating law states, there are requirements for informational filings of rates, rate examinations and reimposition of prior approval authority if adequate competition does not exist. Some of these are not found in the antitrust arsenal (e.g. the power to withdraw the insurer's license to do business). On the other hand, the states possess the same type of enforcement tools available to the Department of Justice.²⁹

(b) *Enforcement capabilities*

In addition to possessing a smaller range of sanctions than do state insurance regulators, the Department of Justice lacks certain basic attributes which detract from its ability to monitor and foster competition in the insurance market. First, the Department of Justice is a judicial enforcement agency. To prosecute violations, it must proceed through the courts with all the difficulties inherent in that process (somewhat mitigated by the consent procedure). The standards applied are those judicially developed by the courts. The department sets no standards of its own, promulgates no regulations and does not act in an administrative capacity. In short, it is not a full regulatory agency. Second, implicit in the judicial approach, is supervision on a case-by-case basis. There is a general absence of continuous oversight. Third, the Department of Justice's jurisdiction extends not only nationwide but also across industry lines. Its responsibilities cover individuals, firms, companies, industries, associations and other persons. Such persons can be active in an infinite variety of fields. Consequently, inherent limits exist as to the amount of expertise which department personnel can acquire concerning the operations, practices, and personalities of a given industry such as the insurance business.

In contrast, a state insurance department is a regulatory agency. It is not limited to the judicial process. The insurance department can hold hearings, issue orders and promulgate rules and guidelines. Consequently, it can respond to developing situations more rapidly by establishing a clearly articulated policy through its rulemaking authority. The insurance department's responsibility is concentrated on insurance. As a consequence, knowledge and experience developed over a period of time better enable the department personnel to monitor the conduct of persons, companies and associations active in the insurance business. Also, the insurance department exercises continuous supervision over insurance companies doing business in its state. Such supervision is not merely limited to rate matters. Thus, the department is in a position to obtain and maintain a broad overview of an insurer's entire operation. Because of the broad scope of its regulatory interest and powers and because of its continuous exercise of jurisdiction, insurance departments possess significant regulatory leverage which the Department of Justice lacks. Furthermore, the enforcement

²⁸ Virtually all rating statutes provide that rates shall not be excessive, inadequate or unfairly discriminatory. Except in open competition states, these standards generally lack further statutory definition. Typically, the open competition statutes provide that no rate shall be deemed excessive if a reasonable degree of competition exists. The basic standard of "excessive" can be interpreted in the same way under a prior approval statute.

²⁹ One exception should be noted. It is not common for a state to seek a divestiture, dissolution or divorcement of a portion of a defendant's business. However, even in the antitrust field, the courts have not been inclined to apply this remedy (resulting in "legal victories devoid of economic meaning"). Ash, "Economic Theory and the Antitrust Dilemma" 206 (1979).

of an administrative agency is more likely to show a consistent and rational pattern than judicial enforcement which depends on courts resulting in a variety of judgments.

Unlike the Department of Justice, the FTC is a regulatory agency with power to promulgate regulations, hold hearings and issue cease and desist orders. In this respect, it is more similar to state insurance departments than is the Department of Justice. However, unlike the insurance departments, the FTC's responsibilities extend across a multitude of industries. Furthermore, FTC activity is primarily on a case by case basis rather than the exercise of continuous jurisdiction. And finally, involvement of the FTC would inject potentially different determinations by conflicting regulatory agencies.

In addition, the various states, both individually and through the mechanism of the NAIC, have the facility to establish a comprehensive statistical mechanism to monitor competition. Currently, the NAIC is in the process of developing a statistical system specifically designed to compile the necessary information to apply the economic tests of workable competition. The combination of the NAIC annual statement, upon which much of the statistics of the insurance business is based, and the states' continuous jurisdiction over insurers afford the potential for monitoring competition which does not exist, to our knowledge, with respect to any other industry.

Finally, Congressional criticism of the antitrust enforcement effort must be noted. The Senate Committees on the Judiciary and Commerce has referred to "the ineffectiveness of our antitrust enforcement effort,"²⁸ "severe staffing shortage of experienced antitrust litigators,"²⁹ "meager" resources,³⁰ etc. The joint report went on to state that "[t]he present economic conditions are to some extent the result of inadequate enforcement of the antitrust laws."³¹ Furthermore, the then proposed Antitrust Enforcement Authorization Act of 1975 (S. 1136) sought to establish a program of assistance and grants to states to improve their antitrust enforcement capabilities on the basis that "the States represent an untapped source of substantial potential in the antitrust area."³²

Subsequently, Congress enacted the *parens patriae* provision which permits state attorney generals to recover monetary damages on behalf of state residents injured by violations of the federal antitrust laws.³³ It seems quite anomalous to vest federal jurisdiction over another major industry when at the same time federal agencies enforcing antitrust laws are subject to serious criticism as to their enforcement effectiveness in the areas over which they currently have jurisdiction. It seems further anomalous to attempt to tap state antitrust potential in general and at the same time attempt to withdraw from state insurance regulators, who increasingly utilize competition as a regulatory tool, their authority to regulate.

2. *The potential limitation of substantial amounts of joint activity through the general application of antitrust is inconsistent with many needs of insurance buyers*

Several aspects of insurance involving legitimate and necessary cooperative activities do not lend themselves to treatment under the federal antitrust laws. In general, these fall into one of four areas (a) pooling of statistics, (b) insurance pools, (c) residual markets and (d) guaranty funds. S. 1710, in essence, leaves residual markets with the states and creates a new federal machinery to take care of guaranty funds which, in turn, poses other substantial problems discussed later. Pooling of statistics and insurance pools are briefly discussed below.

(a) *Pooling of statistics*

The treatment of risk by insurance requires the anticipation of loss by prediction. The degree of accuracy in prediction depends upon the stability accruing from dealing with a large number of homogeneous units of exposure, e.g. automobiles, houses. Without the operation of the law of large numbers, predictions are very apt to go awry. Consequently, the ratemaking process depends to a large extent on the accumulation of a large pool of statistics. Of course, some large insurers (at least with respect to some lines) develop a sufficient body of data from their own experience to lessen or eliminate their reliance on the pool

²⁸ S. Rep. No. 94-499, 94th Cong. 1st Sess. at 1 (1975).

²⁹ *Id.* at 2.

³⁰ *Id.* at 4.

³¹ *Id.* at 5.

³² *Id.* at 8.

³³ Public Law 94-405, Sec. 301 (1976).

of information developed by others. Many insurers, however, are not as well situated. Thus, pooling information is essential to the continued survival of many of the smaller and medium size companies. Two conditions of effective competition are (1) the existence of numerous competing sellers and (2) ease of entry into the market. The availability of pooled information contributes to both. If the federal antitrust laws were applied, insurers' continued ability to pool information would be thrown into doubt (e.g. the Container case).² This would not seem to contribute to a workably competitive market.

(b) Insurance pools

The term "pool" refers to an association of insurers who share premiums and losses among the members concerning one or more specified insurance coverages. Such pools may assume different forms. Pooling may be effected through merely bookkeeping procedures which allocate premiums and losses to members in agreed upon proportions or more extensive operations that underwrite, issue policies, investigate claims and, in general function like an individual insurer.

The formation of pools serves anyone of several essential purposes:

(1) To afford a market for insureds seeking extraordinarily large amounts of insurance to be provided in a single policy. Member companies may be unwilling or unable to provide such coverage individually;

(2) To afford a market for classes of insureds whose operations are such as to require special service facilities not ordinarily furnished by many individual insurers;

(3) To afford a market for insureds whose operations present an exceptionally great hazard, especially in instances in which there are relatively few insureds engaged in such operation;

(4) To afford a market for insureds whose insurance is not acceptable to the individual insurers which comprise the pool;

(5) To afford a medium for insuring special classes of insureds at rates and under rating procedures which differ from those used by the individual company members;

(6) To afford small companies a means of competing with large ones by making available to each pool member the combined capacities of the group.

For example, the nuclear fission pools have been created in view of the overwhelming potential liability stemming from peaceful uses of nuclear fission. Other pools touch such areas as ocean marine hull insurance, the concentrated hazards met in insuring negative films for motion pictures, exceptionally large amounts required by industrial operations, property insurance for rolling stock and fixed properties of railroads, insurance for oil refineries, aviation hazards, etc.

Formalized pools are not the only method to handle such risks. Individual insurers join together on particular risks without the organization of a formal pool. Coordinated activity by insurers through joint underwriting or joint reinsurance serves to spread risks among a number of insurers for those businesses with large risk exposure.

These pools and joint underwriting operations could run afoul of the federal antitrust laws if such were applicable to insurance. In contrast, a major goal of insurance regulation is the ready availability of needed coverage. The pools provide a market for risks that otherwise would be unserved since no single insurer would be able or willing to handle such potential liability. A competitive market composed solely of individually acting, competing insurers could not meet the demands for availability. Thus, a blanket application of the federal antitrust laws to the insurance industry could bring many legitimate and essential functions of the insurance business to a virtual standstill. This would not only adversely affect the insurance industry, it would adversely affect those persons (individuals, companies and industries) unable to obtain needed protection.

3. Potential regulatory vacuum under Federal antitrust laws

The federal antitrust laws attempt to deter anticompetitive conduct and to foster conditions conducive to competition. At the same time, however, the antitrust laws provide no guarantee that effective competition will occur or be maintained. The American economy is replete with industries subject to antitrust

² U.S. Container Corp. 303 U.S. 223 (1932).

laws which have been criticized for not being competitive because of conditions over which antitrust enforcement techniques are either unable or unwilling to correct. (The comments above on antitrust enforcement are relevant here.) Where antitrust is unsuccessful in effectuating vigorous competition, and no other agency has jurisdiction, a regulatory vacuum is created rendering the public vulnerable to abuse. Nevertheless, application of the federal antitrust laws under S. 1710 could produce precisely this result.

The bill would eliminate authority of the states to oversee insurance rates. For those groups of people and for those lines of coverage where competition is not effective, the public would have no protection to potentially exploitive rates. The only potential restraint is the imposition of rate controls. The proposed bill now rejects this potential restraint.

In contrast, the state open competition rating laws are much more flexible. As long as workable competition exists, primary reliance is placed on competition to regulate rates. However, if after applying tests of workable competition, the insurance regulator determines that competition is not effective, he may reinstitute a rate approval mechanism until competition becomes viable again. A regulatory vacuum is avoided and the public is protected. Similarly, the same result can obtain under most nonopen competition states when the regulator applies the statutory rate standards in terms of competition and exercises his disapproval power only where competition is not effective. Consequently, in the context of the insurance industry, the state insurance regulatory mechanism affords a better opportunity to protect the public. States use a blend of competition and other regulatory techniques rather than blind adherence to the federal antitrust laws as proposed by S. 1710.

4 S. 1710 would likely result in Federal rate regulatory control

Despite the intended purpose to foster competition through application of the antitrust laws, it is likely that federal rate regulation would be the ultimate result of S. 1710. Most industries that are subject to comprehensive federal regulation do not compete on the basis of price. Transportation, banks, energy and utilities are prime examples. Granted, there is talk of deregulation, e.g., airlines, but it would undoubtedly take years to build competition to the level now existing in the insurance industry even if such deregulation measures are implemented.

S. 1710, which in effect amends the McCarran Act, is not likely to be enacted in its present form. There has long been an articulate influence on government pressing for increased economic control—including prices and wages—for a broad range of goods and services. Creation of direct federal rate controls is a distinct possibility as a result of favorable consideration of S. 1710. Even if S. 1710 were enacted as introduced, eventual federal rate regulation should be anticipated as a possible future supplemental activity.

A very likely scenario to follow enactment of S. 1710 revolves around increasing insurance rates. Most knowledgeable observers of the property and liability insurance business believe that the application of the federal antitrust laws will do little to reduce rates. (Very rarely, if ever, is the situation such that an insurance regulator will not permit an insurer to reduce rates if it so chooses.) On the other hand, removal of state authority to regulate rates would lead to even greater rate increases than are now occurring because of the insurer's efforts to recover from the recent poor underwriting experience and the concern over the unpredictable inflationary trends. Congressional reaction to sharply rising insurance prices is predictable. Imposition of federal rate controls can be expected to follow substantial insurance rate increases.

Expectation of rate increases is not just simply speculation. For example, on February 1, 1976 the New York prior approval law for no-fault automobile insurance rate expired while the legislature debated what the appropriate time period for an extension would be. Upon expiration, the open competition rating law applied. Immediately several insurers raised their auto rates in New York by averages of 18 percent to 29 percent respectively. Unlike the situation which would prevail if only the antitrust laws applied, under the open competition law the insurance commissioner has the authority to review rate increases after the fact to determine whether they meet the standard of reasonableness. But the important point of this example is the suggestion that those insurers who now support preemption of state regulatory authority in favor of the federal antitrust laws may be doing so not with the view of increasing competition and

lowering rates but rather with visions of free pricing and the opportunity to substantially increase rates.

The prime movers for the adoption of open competition laws in the states (and for the application of federal antitrust laws to the property and liability business as a substitute for state regulation of rates) are certain insurers who want more freedom to increase prices. This has created a dilemma for state legislatures; they understand (and so do we) the rationale of the arguments for open competition marshalled in various papers. But they are also concerned about public dissatisfaction with the cost of insurance in lines like auto, homeowners, medical malpractice, etc. So a majority of the states, with legislators elected by the same people who elect members of Congress, have opted to continue with insurance laws embodying some form of a rate regulatory mechanism.

Few, if any, members of Congress would want to be held responsible for enacting legislation which significantly increases insurance rates. Consequently, the series of inevitable and substantial rate increases following enactment of S. 1710 above and beyond the current pattern, coupled with a Congressional prohibition of state controls, could very well lead to consumer pressures for reimposition of rate regulatory controls to fill the federally created void embodied in the current S. 1710 proposal. Federal rate controls would be far more rigid and inflexible than existing state rate authority.

If reliance on competition is the primary answer to rate control, the states have it in their power to provide it—and in a way that fits neatly into other aspects of state regulation. We do not need Washington to do this job. Furthermore, if open competition does not work, the state open competition laws provide machinery to give prompt relief without changing the whole system and without requiring applications to the courts for injunctive relief on a case by case basis.

5. Antitrust summary

In summary, the S. 1710 recommendations concerning the application of the federal antitrust laws to the insurance industry, if adopted, would work contrary to the interest of the insurance consuming public in at least four general ways. First, the bill would remove from the states the ability to foster competition and ignore the fact that the states are in a better position to perform this function than is the Department of Justice due to the legal standards under which they function, the nature of their enforcement mechanisms, the more specialized scope of their enforcement responsibilities and the current enforcement limitations of the Department of Justice. Second, the application of the antitrust laws to the various needed and legitimate joint activities, in effect, promises to dry up (a) sources of statistical information, particularly for smaller insurers and (b) dry up substantial segments of the U.S. domestic insurance markets, causing substantial availability problems for many business and other insurance purchasers. Third, the proposal would create regulatory vacuum in those areas in which competition does not exist and which the antitrust laws cannot compel. Fourth, favorable consideration of S. 1710 could very likely lead to a massive federal rate regulatory program.

B. ADVERSE IMPACT ON THE CONTINUING STATE INSOLVENCY GUARANTY FUND SYSTEM: A DUAL GUARANTY FUND SYSTEM IS UNWORKABLE

Drafting of this bill proceeded from a consideration of "what steps might be taken to insure protection for policyholders and to improve the quality of regulation for solvency."¹² The bill, however, does not suggest a means to better regulate for solvency other than giving a new bureaucracy the power to regulate for solvency as it sees fit.

To the extent that state guaranty funds are working, and they are, the alternative federal guaranty system could have only the effect of weakening and splintering into two camps the all industry guaranty mechanism. If there is truly concern with the ability of the state guaranty funds to handle major insolvencies, it makes absolutely no sense to diminish the base over which insolvency losses are spread, and thereby reduce its ability to sustain loss. The basic concept of insurance involves the spreading of risk through the law of large numbers of pooled, similar risks. The basic concept of S. 1710 is at odds with this fundamental principle.

If S. 1710 were enacted, it is possible that the shift to federal guaranty status would be made by large, more financially sound, multistate insurers seeing the

¹² 128 Congressional Record S. 10088.

opportunity to avoid guaranty fund assessments that would be used for the benefit of weaker competitors' policyholders. State guaranty funds, meanwhile, would find themselves without the financial backing of insurers controlling much of the industry's assets. Such a result would be bad for the states, bad for policyholders and bad for competition. Fragmentation of the guaranty system would be a highly destructive rather than a constructive effort at reform.

According to Section 103(1) of S. 1710, the federal commission may revoke a guaranty certificate of any participating state or federal insurer upon (a) the request of the insurer or (b) on the commission's initiative if the insurer does not comply with the federal requirements. Since state guaranty fund laws cover all insurers operating in the state, other than those which would be exempted by S. 1710, this bill presents the possibility of dumping terminally ill insurers from the federal guaranty system into the laps of the state funds. In short, S. 1710 would establish a system in which the federal government could skim off the cream of financially stable companies, thereby weakening the state guaranty fund system and possibly dump financially troubled companies back into the weakened state system to the detriment of the policyholders.

Again, it should be recalled that there is no parallel here in the banking industry. Loss of FDIC membership is akin to a kiss of death to members. We have heard no interest expressed by this committee or the Congress in seeing that the states enact competitive deposit insurance mechanisms for banks as a means to improve federal and state regulation. Precisely that, however, is being proposed for the insurance industry.

C. ILLUSORY PROMISE OF LIMITED REGULATORY INVOLVEMENT

Subsequently, we shall review some of the advantages of state regulation over federal regulation of insurance. The strength of these arguments is apparently widely recognized since much of the sales promotion efforts surrounding S. 1710 characterizes the proposal as a dual regulatory scheme in which cooperative federal and state systems complement each other. Similarly, other federal insurance proposals are said to pose de minimus federal regulatory involvement. The bill before you is characterized by proponents as one to improve solvency regulation but one "that does not provide for federal regulation of insurance sales or marketing" nor does it "eliminate the authority of state insurance regulators to prescribe policy content."² This assertion of limited federal regulatory authority is illusory if not blatantly false. The proposition is explicitly betrayed by obvious and specific language in the bill.

For example, Sec. 201 dealing with federal chartering preempts state licensure authority over federally chartered insurers without saying so in so many words. Licensure is the ultimate regulatory control available to the states. A state license confers the privilege of doing an insurance business in the state. The effectiveness of subsidiary state controls necessarily depend upon the ultimate authority to terminate a nonqualifying insurer's privilege to continue its in-state insurance operations. S. 1710, however, provides that a federal insurer is "deemed to be authorized to do business in any state" (Sec. 201(b)(2)(B)). Notwithstanding this deeming of authority, states are supposedly permitted to "revoke the authority" of a federal insurer. However, such revocation must be accompanied by a showing of cause satisfactory to the federal commission. In other words, licensure authority would, as a practical matter, be removed from the state. Without such authority, the states do not have proper control over marketing practices, policy forms, content or other matters purportedly left to the states by S. 1710.

Interesting in itself, the only provision in S. 1710 dealing specifically with regulatory authority (Sec. 107) does not appear in Title II on federal chartering, but rather is applied to all federally guaranteed insurers—both state and federally chartered. Apparently both state and federally chartered insurers would be subject to similar federal regulatory authority. The broad grant of authority to the commission in section 107 is "to prescribe such rules and regulations as may be necessary to carry out its responsibilities . . . this Act."

S. 1710 deletes from a similar provision appearing in its 94th Congress predecessor (S. 3884) a subsidiary requirement that the federal regulator publish

² Remarks of Jeremiah S. Buckley, Minority Staff Director, Senate Committee on Banking, Before the Insurance, Negligence and Compensation Law Section of the American Bar Association, June 4, 1977.

rules "designed to assure the fair, complete, and timely performance of its obligations to its policyholders."¹⁰ Since S. 1710 provides for federal guarantee of all "insurance obligations," part of the commission's responsibilities will undoubtedly be seeing that guaranteed insurers carry out their obligations (as defined and determined by the commission)—whether the bill explicitly says so (S. 8884) or not (S. 1710). This obviously encompasses market conduct and policy matters alleged to be left to state control.

A similar point was underscored several years ago by an Advisory Committee to the U.S. Department of Transportation when that agency analyzed a bill introduced by Senator Magnuson¹¹ to establish another federal guaranty system for insurers:

Inevitably, the federal agency, to protect the integrity of the fund it must administer, will find it has to reach farther and farther in the exercise of the powers conferred upon it or to seek even more powers. Financial supervision is the primary purpose and function of insurance regulation. *The needs of financial regulation pervade the legal controls imposed upon insurers.* Ultimately, it is inconceivable that the federal agency charged with the faithful administration of a fund derived from people in every state will be able to tolerate significant discrepancies among states in capital and surplus requirements, in investment laws, in rate regulation, and in examinations of insurers. *Comprehensive Federal control will, indeed must, follow Federal financial responsibility.* (emphasis added)¹²

DOT agreed with these conclusions of its advisory committee, and the Administration thereafter introduced its own version of guaranty fund legislation eliminating federal regulation.¹³

The broad grant of regulatory authority that would be explicitly granted or at least emanate by necessity from S. 1710 is incontrovertible. We find it curious that this bill is not openly acknowledged as a measure designed to supplant state regulation.

Not only does the bill create broad regulatory authority over both state and federally chartered insurers who partake of the federal guaranty, but also it plants the seed for federal regulation of the entire industry. This fact is illustrated by Section 107(b), which requires the establishment of an early warning system and clearly indicates that S. 1710 contemplates extensive regulatory involvement with the entire insurance industry.

According to the early warning system provision, the commission "may include both federally guaranteed insurers and other insurers." The commission can compel production of "financial reports or records" including computer and HDP information, thereby giving it explicit authority to become, in effect, a regulator of the entire insurance industry. Although the commission may affiliate its early warning system with that of the states, it can also establish its own, thereby generating dual reporting requirements and all the attendant problems—different accounting, different forms, different standards of adequacy, different investment limitations, etc.

Finally, to those unsuspecting candidates for federal charters, it should be pointed out that the promise of limited regulatory involvement of the Federal Insurance Commission includes virtually all authority over policies created under any state insurance law or regulation except with respect to premiums and rates. Section 208(a)(4) provides that in order to commence business (and maintain the federal certificate) the contracts of insurance issued by the federal insurer must be "in compliance with any applicable laws or regulations of the state or states where such contracts are proposed to be issued."

In the last analysis, there can be little doubt that S. 1710 amounts to nothing less than a deep opening wedge for complete federal regulation of the insurance industry. Whether explicitly provided in the language of the bill or not, as the DOT advisory committee put it "[c]omprehensive federal control will, indeed must, follow federal financial responsibility."¹⁴

¹⁰ Sec. 6(a)(4), S. 8884, 94th Cong. 2d Sess.

¹¹ S. 2286, 91st Cong., 1st Sess.

¹² Statement of the Advisory Committee on Economic Regulations to the Department of Transportation Re S. 2286.

¹³ Testimony of Paul Cherington, Assistant Secretary for Policy and International Affairs, Department of Transportation; Hearings on S. 2286, Before the Senate Commerce Committee, 91st Cong., 1st Sess. (1969-1970).

¹⁴ See footnote 28, *supra*.

D. ILLUSTRATIVE TECHNICAL FLAWS IN S. 1710

At this point, I would like to turn to a few technical concerns with S. 1710. Because the implications of this bill touch virtually every aspect of the insurance business, my remarks can only be illustrative rather than exhaustive of our concerns.

The structure of the proposed federal guaranty system and its operations as defined in S. 1710 suggest that the Federal Insurance Commission may have the power to intervene as a third party in determining policy content and conditions—without the need for judicial proceedings. According to Sec. 102(e), any "insurance obligations incurred or maintained, exclusive of the reinsured obligations of a ceding insurer . . . is guaranteed and, upon default of such insurer, such obligation shall be met by the Commission. . . ." The provision could pose tremendous coercive power over federally guaranteed insurers.

Rather than speaking of the guaranty fund kicking in upon impairment or insolvency of an insurer, Sec. 102 of S. 1710 provides for federal payment upon default. "Default" is not defined. Further, "guaranteed obligation" is defined to mean any insurance obligation to a policyholder, claimant, or assignee within "the coverage of the policy." This type of Commission power appears to clothe the new federal agency with unprecedented power to fulfill social objectives and reforms. In the event of a coverage dispute, the Commission could on its own conclude that a "default" had occurred and pay the disputed claim. In other words, coverage could be "deemed" to be included in any policy at the whim of the commission. If Sec. 102(e) means what it says, it would have unimaginable consequences for the insurance business.

Section 102(f) also evidences some lack of understanding about the insurance industry and its operations. This provision suggests that the federal guaranty mechanism contemplates the assignment of insurance contracts of insolvent insurers. In closing banks, we understand FDIC arranges for assumption of deposits by other banks. According to paragraph (f), the Commission is to pay obligations when possible through the insurers to which policies have been assigned. Section 104 also repeats this assignee payment mechanism. If casualty policies of an insolvent insurer are to be continued through a federal commission assignment, the bank parallel again falls down because of the enormous insurance complications attendant to such an assignment. An insolvent insurer's difficulties may well be attributable to poor underwriting, insufficient premiums, or other reasons making policy assignments unattractive. Transferring casualty policies to other carriers would require some means of sweetening the assumption by other insurers or subsidizing the attendant losses on these underpriced coverages or bad risks. No provisions of S. 1710 even suggest the outline of such a transfer mechanism or necessary fair procedures.

We also note the exemption of "reinsured obligations" from those insurance obligations guaranteed by the federal fund. It should be understood by the proponents of this bill that it will most often not be possible to represent federally guaranteed policies as coverages backed up by an agency of the federal government in advertising or communications with the public. For example, a block of business may be reinsured on a pro rata basis with the writing carrier only retaining 50 percent of the exposure. If the writing carrier becomes insolvent, presumably only 50 percent of the policy obligations would be guaranteed by the federal government. Since the policyholder has no privity of contract with the reinsurer, absent an assumption or cut through provision in the reinsurance contract, the policyholder will apparently have to stand in line with other creditors before the liquidator for 50 percent of his claim. Reinsurers, of course, may or may not be federally guaranteed and the "partial" guarantee, where any coverage is reinsured, may prove unsatisfactory. Again, as the DOT advisory committee put it, the federal commission may find itself reaching "farther and farther in the exercise of powers conferred upon it or . . . [seeking] even more powers."¹⁴

Numerous other details of S. 1710 present serious concerns to state insurance regulators and betray the limited regulatory involvement suggested in explanatory comments by proponents. Those issues that we have raised, however, suggest the extent of technical and conceptual flaws which will inevitably make this bill unworkable or require the federal system to operate substantially in derogation of the existing system of state insurance regulation. Neither result is in the public interest.

S. 1710 WOULD DEPRIVE THE PUBLIC OF THE ADVANTAGES OF STATE INSURANCE REGULATION

As noted, S. 1710 would, as a practical matter, involve a substantial preemption of state insurance regulation. We believe on the basis of our regulatory experience that the Congress is ill-advised and the federal government ill-prepared to assume a direct role in regulating the insurance business. Despite claims to the contrary, S. 1710 would necessarily invite a system of federal regulation that would reach farther and farther into the regulatory sphere.

In light of the Supreme Court's interpretation of the scope of the commerce clause, few would argue on the basis of judicial precedent that Congress does not have the constitutional authority to regulate insurance as an incident of interstate commerce.⁴ But, as we broaden the commerce clause constitutionally and concomitantly broaden the powers of Congress, we will ultimately reach a point where there is no subject of legislative concern in which Congress cannot meddle as a matter of right. However, we doubt that most Americans, faced squarely with the proposition of one centralized government, would favor the transference of any and all regulatory authority to Washington. We submit that Congress should pause whenever it has occasion to consider the preemption of a function historically performed by the states.

We are not aware of the circumstances or public policy that would justify an act of Congress designed to wrest insurance regulation from the states or impose a federal guaranty system. On the contrary, most of the proponents of federal insurance involvement of any sort have maintained that state insurance regulation should be left in place. A review of the development and advantages of state insurance regulation should precede any intrusion into this historically state performed activity.

1. Development of State Insurance Regulation

In part due to *Paul v. Virginia* (1868)⁵ which held that insurance was not interstate commerce, the regulation of insurance developed at the state level. As a consequence, insurance was not subject to congressional jurisdiction under the commerce clause. However, in the *SEUA* case (1944)⁶ the Supreme Court reversed this position. To assure that state insurance regulation was not upended under the commerce clause, Congress determined that state regulation of the business of insurance is in the public interest. Specifically, the McCarran Act (1945) provides:

Congress declares that the continued regulation and taxation by the several states of the business of insurance is in the public interest. . . .⁷

Thus, the regulation of insurance continued to develop at the state level and has done so at an accelerated pace in recent years.

State insurance regulation is dedicated to protecting the public interest by focusing on at least four fundamental regulatory objectives: (a) assuring the financial integrity underlying the security promised, through prevention of insolvency and guaranty funds; (b) quality of the product; (c) availability of the product; and (d) fairness to the insurance consuming public. To achieve these goals, a broad and detailed state regulatory mechanism has evolved. For example:

(1) Insurers must obtain and continue their licenses in order to do business. This, in turn, requires complying with statutes and regulations pertaining to formation; financial standards concerning assets, capital and surplus, permissible investments, adequacy of reserves; and qualification as to character of management, experience and knowledge of the business. Licenses may be suspended or revoked for failure to comply with the law or when the public interest so requires.

(2) Insurers must file comprehensible annual and other periodic reports under oath in each state in which they do business. The NAIC annual statement requires detailed information concerning financial condition, underwriting, investments, reserves, etc.

(3) Insurers are subject to comprehensive periodic examination among other things, to ascertain the financial condition of the company, the results of operation, corporate investment and underwriting practices, whether the company is meeting its obligations to its policyholders, etc.

⁴ *U.S. v. South Eastern Underwriters Association*, 322 U.S. 633 (1944).

⁵ 75 U.S. (9 Wall) 160 (1868).

⁶ 322 U.S. 632.

⁷ 16 U.S. Sec. 1011.

(4) By virtue of statutory standards on policy content and the commissioners' policy form approval or disapproval power, much of the source of misrepresentations or other unfair practices is deterred in advance.

(5) Control is exercised over the pricing practices of property and liability insurers by implementing, either through prior approval or subsequent review, the standards that rates shall not be excessive, inadequate nor unfairly discriminatory.

(6) Market practices are controlled by, among other things, laws governing the qualifications and licensing of agents and brokers, prohibitions against certain practices such as false and misleading advertising and representations, defining standards of fair competition, control over policy forms, rate controls in several areas and department investigations of complaints.

(7) The insurance commissioner may, for a variety of causes (e.g., insolvency, refusal to comply with orders, failure to remove officers, etc.), apply for a court order of liquidation, rehabilitation or conservation.

(8) Among the sanctions available for enforcement of the insurance laws are criminal and civil penalties; cease and desist orders; injunctions; removal of officers and directors; fines; and revocation (or refusal to renew) licenses of agents, adjusters, brokers, and insurers. These express powers and sanctions, plus the informal powers, sanctions and alternative modes of relief stemming therefrom, extend far beyond the authority contemplated in S. 1710.

Supplementing the efforts of the individual states has been the NAIC, organized in 1871 and consisting of the insurance commissioners of the several states. The NAIC has sought to promote uniformity where appropriate, develop model laws and regulations for use in various states and has conducted various types of studies and research projects. The NAIC, as a whole, meets twice a year. Various committees meet during the interim. In addition, a central research office has been established. Thus, the NAIC provides a flexible and timely facility to develop and implement change. In short, the NAIC has served as a mechanism to improve regulation and has provided impetus for change.

This discussion is not intended to be comprehensive but rather simply highlights the comprehensive nature of insurance regulation as it continually evolves to meet changing needs.

2. The fundamental concept of federalism

The dispersion of power between the state and federal governments is advantageous and in the public interest. This constitutional tenet is rooted in sound public policy. Undisciplined power tends to become unresponsive at best and corrupt at worst. Effective implementation of the concept of federalism is fundamental to the exercise of such discipline. This concept requires a dispersion in ultimate decision making power and responsibility, and not merely superimposing a federal regulatory agency on top of that of the states. Enactment of S. 1710 would severely challenge the concept of federalism by ignoring the inherent advantages of state regulation. We urge you to recognize the myriad reasons for maintaining state regulation prior to serious consideration of this bill.

3. Advantages of State insurance regulation

Among the advantages of state insurance regulation are (a) its existence, (b) pluralism, (c) threat of a federal alternative, and (d) regulation closer to the people. Let us deal briefly with each of these areas which should receive your deliberate attention before concluding that the national interest requires Congress to wrest insurance regulation from the states.

(a) *Existence.*—The state insurance regulatory system already exists. It utilizes over 50 offices (at least one in each state and multiple offices in several states), employs over 5,100 persons with combined budgets of approximately \$92 million.

As a general proposition, it is more effective and less expensive to improve upon and add to existing institutions than to start new ones. This is particularly true with respect to institutions, such as the state insurance regulatory mechanism, which have demonstrated a willingness and facility to change where appropriate and whose goals in affording protection to the public are consistent with the type of objectives expressed for S. 1710. Assumption of regulatory power by the federal government could sweep away much of the experience and expertise existing in state insurance departments. Such a shift would throw into doubt for years many of the rules under which the business has been accustomed to

function. From the customers' viewpoint, the known local points for applying citizen pressure would be removed, dispersed, or obscured. Furthermore, there is no assurance that the resulting quality of federal regulation will justify the dislocations incident to the change in locus of regulatory authority.

The history of several federal agencies does not give rise to overconfidence. Nothing is so unsure as predicting the full range of consequences of a major change in a complex system. Thus, the fact that the state insurance regulatory mechanism already exists is in itself a powerful argument for its continuance.

(b) *Pluralism, experimentation and vitality.*—A second advantage to state regulation is the pluralism and diversity within the system. It involves regulatory agencies of limited size. It seems clear that the economies of scale taper off as size increases beyond some point while problems of bureaucracy become proportionately worse.

The field of government regulation is imperfectly understood. This lends support to utilizing a number of agencies rather than just one. Such a system is conducive to experimentation and will confine the impact of an experiment until it has been tested. The dispersion of decisional responsibility and power tends to restrict the gravity of the impact of mistakes or miscalculation to a limited area and segment of the population. On the other hand, a dramatic and effective innovation by a particular state is apt to be adopted elsewhere after a period of time and testing.

Pluralism also affords a more fertile environment for greater vitality than does a single national agency. The scope for top creative leadership is greater in a system having several tops. The work of one or more vigorous agencies is contagious. It tends to be imitated, competed with and used as a standard in other states. The problem of keeping regulatory agencies, whether state or federal, imbued with the sense of vitality, capable of self-renewal and change is now and, certainly in the future, a graver public concern than an occasional awkwardness of a multi-state regulatory system.

(c) *The threat of a Federal alternative.*—An extremely important and unique advantage to state regulation is that the threat of a national alternative always hangs over it. State insurance regulatory agencies are subject to review, investigation and embarrassment by Congress which admittedly has the power to abolish the system if it so chooses. As one former insurance commissioner said, "This concentrates the mind wonderfully." Such congressional oversight no doubt stimulates state regulators to do a better job.

In contrast, if a national regulatory agency becomes involved, it would not be as skeptically watched or credibly menaced. Congressional oversight of federal regulatory agencies has not been demonstratively better than state legislative oversight of state agencies. In other words, Congressional oversight of federal agencies has yielded fewer benefits and more adverse side effects than Congressional oversight of state insurance regulation.

(d) *Regulation closer to the people.*—It is an old cliché that the states are closer to the people than is the federal government. The individual member of the public possesses more readily available means to seek redress, to answer inquiries and to apply pressure at the state level. For example, an insurance commissioner and top members of his staff are more accessible than comparable members of the President's cabinet. Furthermore, there are over fifty commissioners, contrasted to one cabinet secretary, to whom resort can be had. State legislators, who can and do make forcefully known to the commissioner of insurance problems of their constituents, are also more accessible and tend to be more responsive to an individual's problems. When ultimate responsibility is vested in Washington, the response tends to be more sluggish and less attuned to the individual's needs and demands.

To the extent that S. 1710 would adversely affect the state insurance regulatory mechanism, we believe it is contrary to the public interest, contrary to a viable implementation of the concept of federalism which is a keystone of our system of government, and should not be enacted.

IV. SUMMARY

Although S. 1710 is proposed as a measure to improve solvency regulation and enhance public protections when insolvencies occur, passage of the bill would, contrary to its intent diminish policyholder protections. Congressional reform or elimination of the state system should, and indeed must if you are to fulfill your responsibility to the public, proceed on a rational course starting with

documentation of state inadequacies. Through S. 1710, it is alleged that states are not adequately regulating for solvency or providing necessary protections to the public. This bill is the verdict and apparently it is proposed that the indictment and its proof be dispensed with.

We submit to you that S. 1710 meets no demonstrated need and fills no critical regulatory vacuum. The magnitude of the potential insolvency problem for the insurance industry, even for the very difficult years of 1974-1975, has been grossly overstated. Even during those years, the industry made money. No domino effect occurred. The amount of guaranty fund assessments are miniscule in relation to the size of the industry. In short, actual experience contradicts the handwringing speculation of some insurers and industry observers. A comprehensive system of insolvency protection for the insurance consuming public—both regulation and state guaranty funds—is in place and it works. Furthermore, despite their commendable performance to date, state efforts are not static. The system is under continuous review for possible improvements. Some are in the works now, others are being considered.

Dividing regulatory responsibility between the states and the federal government and fragmenting the base over which insolvencies are spread will not improve public protections but rather will jeopardize the existing, viable state regulatory and guaranty fund mechanisms. In addition, there is little need to apply the federal antitrust law to the insurance industry since the impact on competition would at best be quite minimal.

Not only is there a lack of demonstrated need for S. 1710 but also its enactment would pose serious adverse ramifications for the insurance consuming public. We have touched on some examples in this statement.

(1) State insurance regulators are in a better position to foster and preserve competition in the insurance industry than are the federal antitrust enforcement agencies.

(2) Some aspects of antitrust laws as applied to certain joint activities (e.g., pooling statistics, providing pooled coverages) would reduce competition and preclude the availability of insurance coverages for certain types of risks.

(3) The preemption of state rate authority not only could weaken insolvency prevention efforts with respect to individual insurers (which is an inherent contradiction in S. 1710), but also create a regulatory vacuum in those markets which are not competitive thereby leaving the insurance buyer vulnerable to excessive rates.

(4) The fragmentation of the guaranty fund system would greatly and perhaps fatally weaken the state system due to the federal government "creaming" the larger and more financially sound insurers.

(5) Regardless of allegations to the contrary, S. 1710 would (a) involve both immediate and long range massive federal insurance regulatory involvement which meets no demonstrated need; (b) essentially duplicate existing state authority; (c) establish the likelihood of wasteful state-federal regulatory conflict and weaken state controls even over nonfederally chartered companies. As a result, the states' ability to respond to public needs will be impaired thereby undermining, not strengthening, insurance regulatory protection.

(6) Furthermore, such federal regulation undermines the fundamental concept of federalism and deprives the public of the inherent advantages of state insurance regulation.

(7) The creation of a new expensive regulatory bureaucracy for insurance must be paid for with tax dollars, creating a new unnecessary and unjustified drain on public resources.

(8) S. 1710 is said to provide an alternative regulatory system which would be available to individual insurers at their option. Obviously, insurers will forum shop to obtain regulation which has the least impact upon its operations. Dual regulation of insurers could set the stage for regulatory competition in laxity, giving the advantage of broad jurisdictional scope to the system attracting and maintaining the largest number of insurers. In a sense, the regulated would be overseeing the regulators rather than vice versa. This process encourages regulation in which the public interest gets lost in the shuffle—a very questionable public policy indeed. For these reasons, among others, we strongly urge you to reject this proposed legislation.

The CHAIRMAN. Thank you very much, Mr. Kinder.
Our next witness is Mr. Mathias.

**STATEMENT OF RICHARD L. MATHIAS, DIRECTOR OF INSURANCE,
STATE OF ILLINOIS, ACCOMPANIED BY MICHAEL HASTEN, CHIEF
COUNSEL**

Mr. MATHIAS. Mr. Chairman and members of the committee, my name is Richard Mathias and I am the director of the Department of Insurance of the State of Illinois.

I have reviewed S. 1710 and understand it to do several things, most significantly:

- (1) To establish a Federal Insurance Commission;
- (2) To establish a Federal Insurance Guaranty Program; and
- (3) To create the option of federally chartered insurance companies.

The proposed Federal Insurance Act of 1977 would drastically alter the existing regulatory scheme of the business of insurance as it is presently understood. Traditionally and by sufferance of Congress, I suppose, the regulation of the insurance industry in the United States has rested with individual States. I should say at this point that I do not unilaterally oppose such a shift of regulatory emphasis as such. Nor do I oppose the concept of Federal regulation of the business of insurance if it will better serve the public interest. In the process of reviewing the proposed legislation, I read with interest Senator Brooke's remarks of Thursday, June 16, 1977 which appears in the Congressional Record.

I noted with interest his keen concern for the financial condition of the property and casualty insurance business in the United States. I too am extremely concerned as to the financial condition of not only the property and casualty insurance companies, but also life, accident, and health companies as that is my primary job. I am, I suppose, primarily responsible for the financial health and well being of those insurance companies which do business in the State of Illinois. Some would say this is the primary responsibility of any regulation of the business of insurance. This acute concern for the financial stability of those companies engaged in the business of insurance is due primarily to the nature of the relationship between insurer and insured. A relationship which is based on a promise to pay in the future, the basis of which is, of course, the ability to pay in the future—or future financial stability. It is my own regulatory philosophy, if you will, that prompts at least a primary emphasis being placed on the financial solvency of any insurance company doing business in Illinois. In my judgment, and although other regulatory actions appear to be more touched with the public interest, the solvency of an insurance company is the very basis upon which regulation should take shape.

I share Senator Brooke's concern; however, I do not necessarily believe that financial solvency of insurance companies will be best regulated, or even better regulated, by the Federal Government. A review of the proposed legislation prompts two questions which, after what I consider careful analysis of the proposed Federal Insurance Act of 1977, still remain. These questions are: Is this type of regulation necessary? And what will it cost? How does it affect the existing pattern of State regulation? And then the technical concerns as to the language of the proposed legislation.

Without careful and systematic analysis of the necessity of these factors, I must respectfully oppose the passage of the proposed Federal Insurance Act of 1977. I assure you, however, that in so doing my opposition is not the product of a reflex States rights mentality. I am in favor of professional and responsible regulation in the public interest, but I frankly am not persuaded that the public will be better served by the proposals of S. 1710.

The CHAIRMAN. Thank you very much.

[Complete statement follows:]

To: The Honorable members of the U.S. Senate Committee on Banking, Housing, and Urban Affairs.

From: Richard L. Mathias,
Director of the Department of Insurance,
State of Illinois.

Mr. Chairman and Members of the Committee, my name is Richard Mathias

Although some will no doubt question what I have to say about the ultimate goal of any governmental regulation, in my judgment any regulatory initiative must have as its principal purpose the public interest. Grantedly, the concept "of public interest" covers a considerable amount of ground. It is vague, amorphous and often times is used to justify all sorts of governmental activity which would have little or no justification otherwise. An incredible amount of things have been done and/or prohibited—"in the public interest." Fairly, more often than not the public interest is served by systematic and responsible government regulation. And while the extent of the service is subject to considerable dispute, in my opinion public interest appears to prevail with more frequency than it loses.

I am prompted to appear before you this morning share to my thoughts relative to the public interest considerations of S. 1710, "Federal Insurance Act of 1977." I do not presume to be the final arbiter of what "is in the public interest." Nor indeed do I pretend to fully understand and/or comprehend what is and what is not "in the public interest." However, I am charged by my office with the regulation of the business of insurance in the State of Illinois, and out of a responsibility to that office and the citizens of the State of Illinois, I had better have some idea what the public's interest is as it relates to the business of insurance at least in the State of Illinois.

I have reviewed S. 1710 and understand it to do several things, most significantly;

- (1) To establish a Federal Insurance Commission;
- (2) To establish a Federal Insurance Guaranty Program; and
- (3) To create the option of Federally chartered insurance companies.

The proposed Federal Insurance Act of 1977 would drastically alter the existing regulatory scheme of the business of insurance as it is presently understood. Traditionally and by sufferance of Congress, I suppose, the regulation of the insurance industry in the United States has rested with individual states. I should say at this point that I do not unilaterally oppose such a shift of regulatory emphasis as such. Nor do I oppose the concept of Federal regulation of the business of insurance if it will better serve the public interest. In the process of reviewing the proposed legislation, I read with interest Senator Brooke's remarks of Thursday, June 16, 1977 which appeared in the Congressional Record. I noted with interest his keen concern for the financial condition of the property and casualty insurance business in the United States. I too am extremely concerned as to the financial condition of not only the property and casualty insurance companies, but also life, accident and health companies as that is my primary job. I am, I suppose, primarily responsible for the financial health and well being of those insurance companies which do business in the State of Illinois. Some would say this is the primary responsibility of any regulation of the business of insurance. This acute concern for the financial stability of those companies engaged in the business of insurance is due primarily to the nature of the relationship between insurer and insured. A relationship which is based on a promise to pay "in the future," the basis of which is, of course, the ability to pay in the future—or future financial stability. It is my own regulatory philosophy, if you will, that prompts at least a primary emphasis being placed on the financial solvency of any

insurance company doing business in Illinois. In my judgment, and although other regulatory actions appear to be more touched with the public interest, the solvency of an insurance company is the very basis upon which regulation should take shape.

I share Senator Brooke's concern, however I do not necessarily believe that financial solvency of insurance companies will be best regulated, or even better regulated, by the Federal Government. A review of the proposed legislation prompts two questions which, after what I consider careful analysis of the proposed Federal Insurance Act of 1977, still remain. These questions are—Is this type of regulation necessary? And what will it cost?

Among the considerations which make up my regulatory philosophy is a concern for the justification of any particular regulatory activity. From my experience, regulation is time consuming and costly. Although I believe it to be absolutely necessary, to allow regulatory activity to burgeon unchecked is, in my judgment, irresponsible. Cost of regulation, whether we like it or not, is eventually passed on. Ultimately, the cost reaches the consumer. The cost of insurance is a question which certainly affects the public interest. Further, the proposed legislation appears to be premised on the theory that state regulation of the financial solvency of insurance companies has somehow been inadequate or inept or just plain not enough. I cannot agree with that premise. Indeed, the history of insurance company insolvencies leads one in the opposite direction. There simply has not been an alarming increase in insurance company insolvencies either in Illinois or elsewhere to my knowledge. Grantedly, there have been economic downturns, if you will, and some occasionally "spectacular" near misses with respect to insurance company insolvency, for example, the Washington, D.C. based Government Employees Insurance Company (GEICO). I am prompted to wonder if the GEICO problem would not have happened with a Federal Insurance Commission or a Federal Guaranty Fund. The facts simply do not support the necessity for a marked change in the structure of insurance regulation as we presently know it. I am not aware of any empirical studies which conclude that a Federal Insurance Commission would be any more vigilant in the regulation of the financial stability of insurance companies than have been the states. The proposed legislation, however, appears to be premised on a notion that the financial solvency of an insurance company, which opts for Federal charter, would be more carefully and systematically viewed than it has under individual state's regulation.

The facts do not support the cost effectiveness of proposed Federal regulation which would run alongside state regulation in this proposed duality. While I do not suggest that such regulation would cost twice as much, necessarily, it will certainly cost more and I am not altogether convinced that the necessary increase in cost will generate better regulation.

I have to date, neither seen, nor am I aware of the existence of any studies which analyze the cost of such proposed Federal regulation. Again, is the public interest served by the addition of a second layer of regulation without first analyzing its necessity and its cost?

I think most regulators, either state or Federal, will agree that deregulation appears to be gaining support, even among the most ardent consumer advocates. When administrative agencies are at times, faultingly trying to "justify their existence" under newly passed sunset laws, it is curious to see a proposal for a Federal Insurance Commission charged with the regulation of the financial activities of optionally Federally chartered insurance companies without the benefit of any empirical studies. If it is determined at some point in the future to be necessary and cost effective, I will be the first to support the passage of such legislation. To date, however, I have seen nothing which persuades me to either the necessity or the cost effectiveness of such a proposal.

In the area of consumer protection—one which is served best by responsive regulation—I am not persuaded that the proposed Federal regulation of insurance companies will be any more responsive or sensitive to consumer needs than state regulation has been. In fact, the mere geographic separation which will obviously occur points to a reduced degree of responsiveness and sensitivity rather than a growth of such sensitivity. Grantedly, the proposed Insurance Act of 1977 appears to limit Federal regulation to solvency matters, and it can be argued that the solvency of an insurance company is not as acutely a consumer issue as are a particular company's claims practices, agents and brokers activities, policy form preparation and the like which have apparently been left to

the states, at least impliedly, by the proposed legislation. I am of the opinion and it has been my experience as a regulator that the financial solvency of a particular insurance company is directly related to the more acute "consumer" issues. I am concerned that a distance will develop which has historically not been the case between regulator/public should the regulatory emphasis shift to the Federal Government.

The regulation of insurance is at times most localized. In Illinois, for example, there are several major local considerations:

- (1) Mine subsidence;
- (2) Mobile insurance claim review units for disasters;
- (3) Redlining in the state's urban areas; and
- (4) The cost of product liability insurance coverage in an industrial state such as the State of Illinois.

While Illinois does not suffer from sinkholes or mudslides, nor has it been subject to earthquakes or hurricanes, these are local issues which are found in other areas of the United States. Again, I think any shift of regulation away from individual states toward Federal Government should be premised on factual determinations that have found a lack of responsiveness and sensitivity on the local level. Should that be found to be the case, I am indeed in favor of either making the local regulator more sensitive or responsive, or absent effectively doing so, shifting the primary responsibility of regulation where responsive and sensitive control can be found.

If the proposed system of "dual regulation" is accepted, I am concerned about the relationship between the two regulators and how that relationship will affect the regulated industry. I am concerned about gaps in regulation where consistency and uniformity are most necessary. For example, most recent Federal ERISA Statutes have caused insurance regulators in the states some serious problems. There is growing concern among state insurance commissioners and/or directors about the rapid increase in what had been termed "multiple employee trusts" which, depending upon your definition of what is "the business of insurance," should be regulated by state insurance departments. Today, however, a number of these entities have been escaping any regulatory control due to the "preemptive" language found in Federal ERISA Statutes. This preemptive language has been used quite effectively, in some cases, by entrepreneurial entities which, in my judgment, are in the business of insurance and have been avoiding state regulation based on the theory that the Federal Government is the proper regulatory body for such entities. I would not quarrel with this position if the Federal Government were regulating these entities. Unfortunately, for the membership and/or subscribers, the Federal Government has yet to regulate them at all. This is not dual regulation, it is no regulation when, in my judgment, regulation of some kind is most necessary. Concededly, state insurance departments have not always acted consistently and uniformly in their regulatory activities when a particular insurance company is found to be operating in more than one state. However, I have not yet encountered a situation when no one is regulating at all. This may become the case, I am afraid, should the proposed dual regulatory scheme become effective.

There will be a time lag before the newly proposed Federal Insurance Commission can commence full scale regulation. How long is yet to be determined. Thus, companies may "escape" regulation for a period of time when in fact regulation may be most vital. I am concerned that sufficient thought has not been given to the transition period between the option for a Federal charter and thus regulation by the Federal Insurance Commission and actual regulatory activity by that administrative agency. Further, even when the Federal Insurance Commission has "sufficiently tooled up" to be regulating, I am firmly convinced that there will be areas which were traditionally regulated by the states which will go unregulated for periods of time. I suppose when something drastic occurs, that particular area will be defined as Federally controlled as opposed to state controlled, but my concern is that it will take a "drastic occurrence" to clarify proper jurisdiction. I can foresee the development of a quantity of case law dealing with the appropriate jurisdiction of the states v the Federal Government as that jurisdiction relates to the business of insurance. In the the meantime, areas of the business of insurance which have traditionally been regulated by the states will lapse, if you will, into the nether-world which exists between dual regulators. The net effect of this proposed dual system of regulation without careful study of its necessity, cost and implementation will be to weaken the system of regulation rather than to strengthen it. Again, is the public

interest served by the addition of another layer of regulation which, from my review lacks specific areas of authority, carefully defined standards of control and clearly unequivocal delineation between two regulators, state and Federal. I am quite frankly afraid that the proposed legislation does not address itself sufficiently to the specifics of dual regulation which in my judgment are necessary if the proposed legislation is to serve its apparent intent.

Beyond the broad concerns as to the necessity, if any, and the cost effectiveness of such regulation, I have some specific concerns with respect to the proposed legislation. For example, Section 100 appears to place Federally chartered insurers under the Federal Anti-Trust laws. However, in the same section, the proposed legislation provides that the "Insurance Commission shall not adopt any rule or regulation, or exercise any other authority granted to it under this Act in such a manner as to impose a burden on competition not necessary or appropriate in furtherance of the purposes of this Act, and in all cases shall adopt the least anti-competitive alternative to protecting policyholders and the public interest." This apparent inconsistency is somewhat confusing. Is the proposed legislation suggesting that the Federally chartered insurance companies are governed by the Federal Anti-Trust laws, but the Federal Insurance Commission may adopt a rule or regulation or exercise authority which is "necessary and/or appropriate" which imposes a burden on competition and must adopt the "least" anti-competitive alternative to protect policyholders and the public interest? It appears then that this Act would vest the Federal Insurance Commission with the ability to adopt rules and regulations which are minimally anti-competitive which would otherwise be in violation of Federal Anti-Trust laws. As this Committee is no doubt aware, at the sufferance of Congress, the business of insurance is not subject to the Federal Anti-Trust laws to the extent that state regulation controls. I am very concerned about the effect of a dual system of regulation of the business of insurance which on the one hand places Federally chartered insurers under the Anti-Trust laws, allows the Federal Insurance Commission to adopt rules or regulations which may be anti-competitive however controlled by "least anti-competitive alternatives" and on the other allows the Federal Anti-Trust law exemption to continue to exist as regards non-Federally chartered insurers so long as the state regulates the business of insurance. The potential for inconsistency in the regulation of Federally chartered insurers and non-Federally chartered insurers is massive.

The proposed legislation does not appear to address itself with any degree of specificity, detail or clarity to what could potentially be a serious dichotomy between what the Federal Insurance Commission may or may not determine to be "least anti-competitive" and what state regulators have and continue to do in regulating the business of insurance in the marketplace. If the proposed legislation were to be passed in its present form, I fear years and years of litigation which would never ultimately resolve the issue and would effectively throw the delicate balance of the place of the insurance industry within industry generally in the United States into severe imbalance.

The proposed legislation in Section 107(C) appears to prohibit unfair discrimination by Federally chartered insurers in refusing to insure individuals solely because of age, sex, race, religion or national origin. This is purely a laudable objective. However, I am concerned about the coordination of the Commission's rules and regulations relative to the enforcement of this provision, and how those rules and regulations would interact with individual state efforts to eliminate such arbitrary, unfair discrimination. Further, while the proposed legislation prohibits unfair discrimination in certain areas, it appears to conclude that rates and/or premiums will not be considered to be unfairly discriminatory if such rates and premiums are supported by empirical evidence demonstrating that the creation of classes ordinarily discriminatory on their face, are reasonably "predictive of and significantly correlated to loss and expense experience." The relationship between the determination of unfair discrimination and discrimination based on loss and expense experience is further complicated by the assurances by the author of the bill that it will not impinge on individual state rating or premium review authority. The proposed legislation's Section 204 regarding the applicability of state law is another area of concern. There is a marked lack of clarity as to the intention of the Act as relates to the taxation of optionally Federally chartered insurers by individual states. The State of Illinois derives a significant amount of revenue from the taxation of insurance companies doing business within its border. The effect and legislative intent of Section 204 as it relates to state's taxation of the business of insurance is unclear.

Regarding the proposal for a Federal Guaranty Fund, several individual and specific concerns are of note. Under the proposed language of Section 104, the Guaranty Fund would assume all policy obligations of the insurer. Yet under Section 102, it appears that there is an excision for the guaranteed insurer's reinsured obligations from coverage by the Guaranty Fund. I am concerned that this would necessitate a potential claimant pursuing recourse against both the Guaranty Fund and the reinsurer, thus being excessively burdensome if not potentially unavailable at all.

There is a simple question which the proposed legislation does not answer, and that is, when does the Guaranty Fund initiate paying claims? Again, Section 104 requires an "adjudicated insolvent insurer" while Section 102 provides that an insurer be in "default." It is vital that the interaction of the Guaranty Fund's assumption of obligations be clearly delineated by and expressly provided for. Further, the interaction between the Guaranty Fund's assumption of obligations does not at all relate to state liquidation procedures which, frankly, in the case of insolvent insurers have proven to be quite effective. Nor does the language relative to the Guaranty Fund's assumption of obligations relate in any way to state liquidation procedures which are necessary to terminate the livelihood of a state licensed insurer.

Under Section 102 of the proposed legislation, the Insurance Commission shall establish and collect from each insurer guaranteed under this Act an annual fee calculated as a percentage of its net direct premiums, and such fee may not exceed one fourth of one percent per year. However, the proposed language goes on to say that the "Commission may establish different levels of fees for different 'types' of insurers" and nowhere in the Act is the word "type" defined.

The Capital surplus requirement as set forth in Section 108 is not defined either for the Guaranty Fund or for purposes of chartering a potential Federally regulated insurer under Section 202.

While I am sure some of the particular inconsistencies of the Act are subject to amendment, my purpose in pointing them out is to demonstrate that I am not convinced or persuaded that sufficient thought has been given to the overall effects of what I consider to be a drastic shift in the regulatory scheme of the business of insurance in the United States. In fact, what has been proposed as a plan for the tightening up, increase and improvement of the quality of insurance company regulation, may well indeed do precisely the opposite. The possibility of the collapse of an individual company engaged in the business of insurance is indeed real. To suggest otherwise is incorrect. However, it may be equally wrong to suggest that because individual insurance companies face the possibility of insolvency, an untested and unstudied system of dual regulation should be established. I, not unlike Senator Brooke and indeed perhaps more so out of my responsibilities and obligations as the Director of Insurance of the State of Illinois, am concerned about the financial stability of insurance companies. It is out of this concern that I have carefully reviewed the proposed Federal Insurance Act of 1977. After this review and the review of related materials available to me in my state, from my limited experience as a regulator in one state, I must conclude that the proposal on its face will not increase the stability, financial or otherwise, of insurance companies doing business either in Illinois or elsewhere. Without careful and systematic analysis of the necessity and cost, together with the particular language of proposed legislation, I must respectfully oppose the passage of the proposed Federal Insurance Act of 1977. I assure you my opposition is not the product of a reflect "states' rights" mentality. I am in favor of professional and responsible regulation in the public interest and I am, frankly, not persuaded that the public will be served by the proposed R. 1710.

The CHAIRMAN. Our next witness is Mr. James Stone.

**STATEMENT OF JAMES M. STONE, INSURANCE COMMISSIONER,
COMMONWEALTH OF MASSACHUSETTS, ACCOMPANIED BY KEITH
R. RODNEY, DEPUTY COMMISSIONER OF INSURANCE, COMMON-
WEALTH OF MASSACHUSETTS**

Mr. STONE. Thank you, Mr. Chairman.
[Complete statement follows:]

STATEMENT OF MASSACHUSETTS INSURANCE COMMISSIONER JAMES M. STONE

Mr. Chairman, I appreciate the opportunity to comment this morning on Senate Bill 1710. In my view, Senator Brooke's bill to permit Federal chartering of insurance companies has already accomplished something of importance. It has fostered a long overdue debate on the appropriate Federal role in insurance regulation. While I can not urge passage of Senate 1710 as it is presently drafted, my opinion of the bill is essentially favorable. I can not share the sentiments of those state Commissioners who feel that any Federal scrutiny of the insurance business represents an unwarranted encroachment upon the rights of the sovereign states. On the contrary, I regard an increased Federal presence in the regulation of insurance as both inevitable and desirable.

To those unfamiliar with the subject, it must be a source of some mystery that the insurance business is not already regulated on the Federal level. The reason lies in a quirk of history. In 1800, the United States Supreme Court, in *Paul v. Virginia*, ruled by some abstruse logic that the business of insurance was not "commerce". If insurance was not commerce, of course, it certainly could not be interstate commerce, and thus there was no constitutional authority for Federal regulation. Accordingly, when the Sherman Act and the Clayton Act were passed many decades later, insurers were automatically presumed to be excluded.

Insurance was similarly left out when the New Deal brought the second great wave of regulation. Under this peculiar umbrella of protection, insurance companies were free for many years to violate with impunity the anti-trust and business practice standards which bound virtually every other industry. Had it not been for *Paul v. Virginia*, there would very likely be a Federal Insurance Commission today, and Senate 1710 would be unnecessary.

The legal environment changed dramatically for insurance companies in 1944. The Supreme Court reversed its earlier position and declared, in *United States v. South-Eastern Underwriters Association*, that insurance had, in fact, been commerce all along. To hold off a Missouri indictment of twenty-seven insurance executives for criminal anti-trust violations, Congressional protection had to be sought by the industry. A massive lobbying effort was constructed and Congress responded in 1945 with the passage of the McCarran-Ferguson Act. McCarran-Ferguson restored the exemptions of insurance from the Federal Trade Commission Act and most of the Sherman and Clayton Acts, but only to the extent that insurance was regulated under state law. Continued state regulation was thus reinforced by specific Congressional action. A nineteenth century court decision and a twentieth century legislative act constitute the principal reasons why insurance today remains the largest national industry subject primarily to regulation at the state level.

Since the passage of McCarran-Ferguson, state regulation has held undisputed primacy in matters of insurance. The arguments for a Federal presence, though, have never quite been stilled. It is generally agreed that the Federal government could provide a useful standardization across state lines in most aspects of the regulatory function. It is widely accepted that Federal jurisdiction would more closely match the interstate nature of the regulatees. The economies of scale that would result from a single regulatory agency instead of fifty are hard to dispute. To these arguments I would add one more. The active scrutiny of the national press corps tends to provide a better shelter at the Federal level against incompetence and inappropriate influence than exists at the local levels. Arguments for continued state regulation usually revolve around the need for flexibility and experimentation from state to state. Companies, and some consumer groups, feel that they have more access to regulators on a localized basis than they would in Washington. The issue is not easily resolved in abstract terms.

A functional analysis of the work of Insurance Departments provides some useful specificity. Our work in the Massachusetts Department can be divided into three categories, each potentially different with respect to the appropriate Federal role:

First, there is Solvency Protection and Company Licensing. Budget allocations for this function have traditionally been higher than for all our other jobs combined. We must evaluate every new applicant wishing to do business as an insurer.

We examine every license on a triennial basis. We seek to prevent insolvencies and, if unsuccessful, we must manage the receiverships. In my judgment, there is every reason to believe that the Federal government could do a better job. State examining personnel are chronically underpaid almost everywhere. Pre-licensing examinations are redundantly performed up to fifty separate times. The various

states squabble over control and order of payment whenever an insolvency occurs. Truly interstate businesses ought to be Federally chartered and examined.

Senate Bill 1710 is soundly drafted with respect to examinations and insolvency protections. The framework for the independent regulatory commission it proposes is far superior to the present construction of the Federal Insurance Administration. The Federal Insurance Guarantee Fund it would establish is sorely needed to coordinate interstate receiverships and to assure coverage in those states without insolvency funds.

A second set of Insurance Department duties relates to the Monitoring of Business Practices of companies and agents. The Massachusetts Department deals with over 10,000 consumer complaints every year. Some are resolved when the applicable law and contract terms are carefully explained to the consumer. Others trigger informal or formal settlement hearings. The most serious result in investigations by our staff and ultimately may lead to disciplinary actions. The Department continually surveys insurer advertising and examines policy forms for truthfulness and clarity.

In these areas, there is a less compelling need for Federal assistance than in protection against insolvency. I cannot fault Senate Bill 1710 for leaving the supervision of business practices, at least for the immediate future, at the state level. On some later occasion, were this bill to become law, I would probably recommend that the Federal Insurance Commission be authorized to look at the interstate business practices of insurers. Too many improper practices are repeated in state after state, and too much jurisdiction confusion arises when improprieties are conducted across state lines.

Rate regulation in the casualty lines comprises the third element of Insurance Department responsibility. It receives the lion's share of public attention and it is, by far, our most difficult task. Commissioners must not only seek to prevent insurers from reaping excess profits; they are also charged with maintaining markets where insurers are unwilling to write and with assuring that the relative rate structure for all policyholders is fair and non-discriminatory. Senate Bill 1710 would take a step forward by repealing the McCarran-Ferguson anti-trust exemption. There is little evidence that state regulation holds down overall profit margins more effectively than would vigorous anti-trust enforcement. Unfortunately, though, Senate Bill 1710 would take a step backwards in freeing insurers from state laws which regulate relative rate structures outside of the compulsory pools and assigned risk plans.

This year has seen a great turmoil in Massachusetts concerning the price of automobile insurance. My experiences in recent months have persuaded me that competition among insurers is not, and may never be, sufficient to assure an equitable rate structure. Insurance prices are not marginal cost prices. They are crude estimates of future cost based on group statistics. I am not convinced that young males with perfect driving records should pay more than young females just because a relatively small fraction of other males have poor driving records. I am not convinced that urban residents should bear the burden of commuting traffic which raises the likelihood of their being involved in collision accidents. I am not convinced that the honest people of our cities should pay the full freight for the social problem of urban crime, which raises the cost of theft insurance.

New thought is evolving around the country on these issues. The Massachusetts Department intends to study them carefully at a hearing to be held next month. Senate Bill 1710 would remove the state's authority to demand a fairer rating structure. This is one case where, during a period of evolutionary thought, state-by-state experimentation is extremely valuable. Federal law might be useful some day in mandating an equitable rate structure. It is counterproductive if it freezes in the status quo. Senate Bill 1710 would be a better bill if it simply deleted the sections dealing with rate regulation.

Mr. Chairman, I urge you to approach Senate Bill 1710 with an open mind. Do not be overly concerned that Federal regulation of insurance appears to contradict historical precedent. Do not be overly calmed by those who would assure you that all is well with regulation by the fifty states. Federal scrutiny of the insurance business, particularly with respect to its financial soundness, should have been established long ago.

With me this morning is Deputy Commissioner Keith R. Rodney of the Massachusetts Insurance Department. Mr. Rodney's responsibilities with the Department include supervision of our entire examination and solvency protection effort. He is a C.P.A. by background and just this summer served as receiver in the successful rehabilitation of a troubled domestic life insurance company. His

comments may be useful to the Committee in documenting the advisability of a Federal presence in the areas he handles.

STATEMENT OF MASSACHUSETTS DEPUTY COMMISSIONER OF INSURANCE KEITH R. BODNEY

Mr. Chairman and Committee Members, I support the sections of this bill which deal with the regulation of insurer financial soundness. The regulation of the financial stability of companies doing interstate business and the administration and funding of insolvencies should not be done on a fragmented state-by-state basis. The present fifty-state regulatory structure acts to complicate the process of regulation and adds significant duplicative costs. Proof of the system's weakness is easy to find. State audits were not effective in identifying or preventing the insolvencies of Equity Funding, Gateway or twenty-one other companies in the last several years.

The states are not likely to remedy the problems which account for their lack of success in this area. State examiners' salaries are often insufficient to attract competent auditors. The average entry level salary is approximately \$11,000 in New England Departments. This compares with approximately \$15,000 offered by private CPA firms. There is no easy solution to the jurisdictional disputes over examinations. Many states are free to participate independently in each audit. This often results in the performance of costly and unnecessary repetitive audit work. An even greater justification for federal financial regulation becomes apparent when companies are in financial difficulty.

In 1975, the Summit Insurance Company became insolvent and a receiver was appointed in New York. Most other states appointed ancillary receivers and hired counsel to be paid out of Summit's assets. The ancillary receivers fought over payment priorities so New York had to hire local counsel in several states, including Massachusetts. They were also paid out of Summit's assets. As a result, payments to Summit policyholders were delayed for many months. An unreasonable share of Summit's assets was consumed by the jurisdictional disputes.

Two weeks ago, the Empire Mutual Insurance Company was placed into rehabilitation and declared insolvent in New York. Only New York State policies now remain in force and only claims by New York residents will now be paid. Out-of-state policies are being cancelled and no claims are being paid. Yet, many state insolvency funds are refusing to pay the claims in their states because the company is not being liquidated. As of today, there is no mechanism for paying a penny to non-New York policyholders.

We are fortunate that there has not been a major life insolvency in recent years. Most states, including Massachusetts, provide no insolvency protection at all for life and health insurance. Unpaid policyholder claims in these lines would produce personal catastrophes far worse, in many cases, than those in casualty lines.

The Federal Insurance Guarantee Fund suggested by Senate 1710 is an excellent model for better consumer protection. Like the Federal Deposit Insurance Corporation in banking, it would provide far better financial security for the public than any state system is ever likely to do.

The CHAIRMAN. Well, thank you very much. I take it—what is your name, sir?

Mr. HASTEN. I'm Michael Hasten, general counsel for the Department of Insurance for Illinois.

The CHAIRMAN. Fine. I take it you have no statement?

Mr. HASTEN. No, Senator.

The CHAIRMAN. All right. The witnesses that we have here certainly provide a good variation in view, which is very healthy and useful. I want to once again congratulate Senator Brooke on introducing this bill. I'm not a cosponsor of it. I may oppose it, but I think it's an excellent initiative to provoke the kind of full-fledged open debate on the problems involved that we have needed. We haven't done this and I think we now have an opportunity to do it.

Furthermore, it's not a mandatory proposal. It's a voluntary proposal. No insurance company is forced to become regulated by the *Federal Government*. They can volunteer if they wish to do so, as I

understand it, to get a Federal charter and then they would be under Federal regulation.

Furthermore, it has the great advantage, as I see it, of providing for those insurance companies that do opt to go Federal to be subject to antitrust laws and therefore to provide a greater degree of price competition to the benefit of consumers than we have had in the past.

Having said all that, I wonder if we do have much of a case really for a new Federal agency to step in on this basis. We have the cost issue Mr. Kinder so ably expressed and I would like to ask first, Mr. Stone, if we really have—in relationship to the size of this industry—after all, with premiums of \$57 billion a year—do we really have any kind of record of abuse, record of loss, that would warrant a new initiative of this kind? Isn't this an industry that functions rather well in spite of the antitrust limitations still with quite vigorous competition? What is the case under these circumstances for moving or having the Federal Government move in with all the shortcomings and weaknesses that Federal regulation has exhibited in the past in so many areas?

Mr. STONE. Well, Mr. Chairman, if the standard for establishing a Federal agency was that there had to have been a disaster or there had to be a disaster pending, I guess I would say that there is not a strong case. I think that the case is based more on the commonsense and efficiencies of some standardized regulation rather than any potential disaster.

I would think that there's a good case for having a Federal regulatory presence any time you have a business which is as large as this one, which demands regulation at some level of government as this one does, and which is so truly interstate in nature.

I'm not certain that the burden of proof should be so high as you suggest.

The CHAIRMAN. Well, the only concrete data that I have seen, Senator Brooke pointed out there was a \$7 billion or \$8 billion casualty loss. Mr. Rodney has referred to the Empire casualty failure and the fact that some policyholders are losing. It would seem that there should be, in an industry as comprehensive and covers literally millions of American businesses and families, a clear documentation of need than we have here for this kind of additional departure.

In view of the arguments that the other gentlemen have made that we are trying to move against unnecessary agencies with sunset laws and trying to end regulation where we have it and trying to eliminate redtape and duplication as much as possible—

Mr. STONE. Well, I can't give an answer that meets that standard, but I guess I feel that a stronger a priori case exists for Federal regulation than these do even for State regulation; that if there were no regulation at all of insurance and we were trying to construct the most reasonable regulatory system, we would probably set it up on a Federal level. So much of the business is interstate, particularly the financial practices and insolvency work, that it would seem to me that it was only because of what I think was essentially a mistake of the U.S. Supreme Court in the 19th century that this didn't happen in the first place.

The CHAIRMAN. Well, you can say that. The absence of action on the part of Congress and on the part of Presidents of the United States failing to call for this for over 200 years has indicated that that

need wasn't perceived. As you know, there's been an awful lot of progressive, reform-minded Congressmen and Presidents in the past. Franklin Roosevelt never called for it. Woodrow Wilson never called for it.

Mr. STONE. They couldn't have. Only after 1944 did the U.S. Supreme Court recognize that insurance was interstate commerce.

The CHAIRMAN. You've got John Kennedy and Lyndon Johnson and a lot of other fine Democratic Presidents.

Mr. STONE. Yes; that's correct.

Senator SCHMITT. Would the Senator yield?

The CHAIRMAN. Yes.

Senator SCHMITT. I'm not so sure Franklin Roosevelt worried about the Supreme Court in the early days. [Laughter.]

The CHAIRMAN. Well, Mr. Kinder. I think Mr. Stone has made some good points, as has Senator Brooke. After all, this is a huge, huge business and to pretend it doesn't represent interstate commerce is pretty unrealistic. The largest corporation in our State of Wisconsin, for instance, is Northwest Mutual Insurance Co. with over \$7 billion in assets—mammoth—dwarfs the banks and everything else and, of course, it's clearly an interstate commerce. There's no question about it, at least in interstate relationships.

Yet these firms are regulated only at the State level. Isn't it inefficient, ineffective for 50 different States to examine and license the same large companies over and over again with differing approaches, differing views, differing rules? Doesn't it make sense in that way to provide at least an option on a voluntary basis for a truly national insurance company—and so many of them are—to go national? Why wouldn't that be a reasonable approach?

Mr. KINDER. Well, I believe that since these others are in place and have been functioning that the introduction of the Federal effort would be an additional set of rules which each of the companies plainly would be subject to and it would add further to that work effort that you described.

I believe that once a company has gone through the admission process in the several jurisdictions it does not find the renewal process—that is, the subsequent examinations and renewal of its certificate of authority in the different States—to be a particularly onerous burden. I think if that were true and the insurers believed that a single regulatory agency would provide relief from a heavier burden, that they would be here urging the adoption of this legislation.

The CHAIRMAN. Do you agree with that, Mr. Stone? Do you feel there wouldn't be an elimination of some duplication if we had the Brooke bill law? Wouldn't it be, to some extent at least, an opportunity for firms to come under a Federal regulation? Wouldn't they be able to escape from some of the duplicating restrictions that they have got with 50 States?

Mr. STONE. One of the reasons that I'm attracted to parts of this bill is that I would assume that if the Federal Government were performing examinations that some of the examination load now on the States would be lifted. Both from the point of view of the companies and from the point of view of the State treasuries, that expense and that burden would be gone because the Federal Government would

be performing it and somewhat better. That's an assumption that I make.

If it's solely an addition to regulation, then I might feel somewhat differently about it.

The CHAIRMAN. Let me ask Mr. Mathias if he could respond to this. You indicated I believe—and perhaps I misjudged your statement—that the Federal chartering section of S. 1710 which would bring participating companies under the Federal antitrust laws would not work in the interest of the consumers and would ultimately lead to Federal rate regulation.

On the other hand, the Justice Department testified yesterday that the structure of the insurance industry is basically competitive and one of the industry witnesses appearing later today contends that open competition laws in some States have been working well.

Why do you believe that competition and antitrust enforcement would be ineffective substitutes for State rate regulation and would lead to rate regulation at the Federal level?

Mr. MATHIAS. Well, in Illinois we do have the most open of open competition. I do believe that a competitive system is in the best interest of the consumer. I believe that my concern about this proposal is based on a number of items, one of which is the effect that it will have on State regulation. We have not well defined at all the startup problems of a Federal regulatory concern. One of the problems that we are now facing in our State is how to deal with the recent type multiple employer trusts and I think you could carry the analogy forward to the startup of a Federal regulatory agency, whether there will be dramatic gaps in regulation during the transition period.

And my comments were directed, Senator, to the question of: No. 1, has the system of State regulation been proven to be so inadequate that a new Federal role is required and the cost of that new regulation and its effect upon State regulatory activities?

As far as the McCarran Act and competitive rating or regulating competition, it's the philosophy of the Department of Insurance that that is an appropriate manner for companies to compete and for departments to regulate.

The CHAIRMAN. Senator Brooke. My time is up.

Senator BROOKE. Thank you, Mr. Chairman.

Mr. Kinder, I certainly was not surprised at the position that was taken by the National Association of Insurance Commissioners, but sometimes I think the association makes a mistake when it comes in talking about massive overbeaming Federal regulation. That certainly is not the intent of S. 1710.

And then you speak about the underwriting losses and you say, well, the most important thing is the bottom line—if you lose \$7 or \$8 billion, you can make it up in investments. That's all right, but I don't believe you want to see \$7 or \$8 billion in underwriting losses. I can't conceive that the industry is satisfied with that record.

And there was potential disaster a few years ago but you state that S. 1710 meets no demonstrated need. And while it's certainly true that we are not today faced with an immediate crisis, I cannot agree that no need has been demonstrated.

Now yesterday we heard testimony from Chairman Harold Williams of the SEC of the quality of insurance regulation across the country is uneven, that some States are not properly staffed to regulate for solvency purposes. Commissioner Stone touched upon that himself in his testimony this morning. Then, even with its limited regulatory responsibility for the insurance industry, the SEC has uncovered several cases of serious abuses, most of which apparently were not detected by State insurance departments before SEC investigation. And the SEC feels compelled to expand the limited staff it has assigned to insurance investigations.

Then testimony was also received yesterday calling into question the extent to which we can rely on the NAIC convention statement which requires neither an audit by independent accounts nor periodic reporting.

Then Robert Hunter of the Federal Insurance Administration yesterday revealed that while surplus lines insurance business is expanding rapidly, State guarantee funds offer no protection to out-of-State insurers, and failures such as the recent failure of the All Star Insurance Co. will leave some policyholders without any protection.

Commissioner Stone and Deputy Commissioner Rodney testified this morning that most State examiners' salaries are insufficient to attract competent auditors, that multiple examinations by the several States result in the performance of costly and unnecessary repetitive audit work by the States.

Then it's been revealed that since the Empire Mutual Insurance Co. was declared insolvent 2 weeks ago there's no mechanism for paying claims of non-New York policyholders.

Then most States have yet to adopt laws providing guarantee fund protection for life insurance policies.

Then State insurance guarantee funds have yet to cope with a major insurance company failure and many knowledgeable observers question their ability to do so.

Now I could go on and on, but my point is that your statement that no need has been demonstrated, in my opinion, is somewhat too strong, I think, for the association to have made. Do you want to comment on that?

Mr. KINDER. Yes. You give me much to comment on, Senator.

First of all, I think that the system of State guarantee funds has responded to the needs as they have arisen. You cite the recent *Empire* case and I'm not that familiar with it. I don't know the reasons why the State guarantee funds in States other than New York would not respond to that if, in fact, they don't.

With respect to the potential insolvency of a major company being such that the system of State guarantee funds could not respond to it, I guess there's always that threat. I don't know how substantial the State funds would have to be to be able to appear to be able to deal with a potential insolvency. No matter how large they were, no matter how responsive, no matter how great the funds may be available to meet that contingency, one could always conjure up an insolvency that was greater than that.

I recall back in 1965 following the Watts riot in Los Angeles, which originally was estimated would cost the insurers some \$44 million and

I think ultimately the actual cost was less than half of that—but various people who were concerned about the riot activity and certain other climatic conditions that we have in California believed that it would be possible that organized rioters would move into the brush area and ignite brush in a number of different places during the height of one of our Santa Ana winds and as a result everything in the entire Los Angeles basin would be destroyed so that the aggregate loss as a result of a single occurrence might be something like \$60 to \$100 billion.

One can always conjure up that kind of situation and I can't believe that the facts in anything we have seen, including the threat of the insolvency of GEICO a year or so back, is such that the existing systems could not deal with it.

Senator BROOKE. Do you think the existing systems could have dealt with GEICO?

Mr. KINDER. I believe that it could. I think that there may have been a limited number of States who would have found it burdensome. My own analysis of the GEICO situation was such that I believed its problems were greatly exaggerated and I think it was worked out satisfactorily far short of the dire consequences that were predicted when that first came to the attention of the public.

Senator BROOKE. Are you familiar with the All Star Insurance Co.?

Mr. KINDER. Yes; I am.

Senator BROOKE. Is that company licensed to do business in the State of California?

Mr. KINDER. It is.

Senator BROOKE. At the time that All Star was licensed in California, what check was made into the company's financial viability?

Mr. KINDER. The company applied for admission to California after it had been operating there on a nonadmitted basis and it was subjected to the same scrutiny that any other insurer would be who was applying for admission. Its more recent examination report was reviewed. Our financial analysts looked at all of the factors involving that company and made a determination that it did indeed pass the requirements that our law requires that a company must before it can be admitted.

Senator BROOKE. Well, All Star was chartered in the great State of Wisconsin. Was the insurance regulator of the chartering State in Wisconsin consulted?

Mr. KINDER. Yes. One of the things that California requires prior to admission is a report of the examination by the domestic State that had been completed within the 3 years immediately prior to the application for admission, and our financial analysts would be in contact with the domiciliary State regarding any question that arose from the review of the material submitted.

Senator BROOKE. That's a regulation. Do you know if, in fact, that was actually done?

Mr. KINDER. I do not know that our people made specific inquiry on that application. I know as a matter of fact that our analysts are quite thorough and if there was anything that required attention that they would have contacted the domiciliary State.

Senator BROOKE. Are you aware that All Star wrote over \$1 million in surplus line business in New York and \$1.9 million in Louisiana in 1974, though it's not licensed in either State?

Mr. KINDER. I was not aware of the specific figures of its writing as a not-admitted carrier. It did, in fact, in years prior to 1975, write on a nonadmitted basis in the State of California.

Senator BROOKE. You know that they did write in Louisiana and in New York, but you just don't know the actual amount. Is that correct?

Mr. KINDER. I don't know the States in which they operated, Senator, but I certainly have no reason to question the figures you cite.

Senator BROOKE. If you accept what I have stated to be fact, what protection do the New York and Louisiana policyholders have in the event of an insolvency?

Mr. KINDER. As far as I know, they are not protected by—the guarantee acts of the States do not apply to policies written by a non-admitted carrier. They do not in California.

Senator BROOKE. Now, if All Star were not licensed in California, would surplus lines policyholders in California be protected against All Star's insolvency under the California guarantee?

Mr. KINDER. They would not. At least that is our interpretation of the statute as it reads. It has not been tested in court and I understand there are some who question it.

Senator BROOKE. Now, Mr. Mathias, I see that All Star wrote \$404,000 in surplus line insurance in Illinois in 1975. Will your policyholders be protected under the Illinois law?

Mr. MATHIAS. The provisions of the Illinois guarantee fund would not cover the surplus lines carried.

Senator BROOKE. Now on December 10, 1976, the National Underwriter contained an article by Richard Wiley entitled "Surplus Lines Take Premiums of 51 Percent." At least two of the companies listed in that article as surplus lines writers, All Star and Glacier, have become insolvent. Shouldn't we be concerned about what happens to the surplus lines policyholders of these companies and their claimants?

Mr. KINDER. I think that we should have some concern about any policyholder who might be left uncovered in such situations. My reading of S. 1710, however, does not suggest that that legislation addresses that specific problem.

Senator BROOKE. I suggest you reread it, Mr. Kinder. I think it does address itself to that.

Mr. KINDER. Only if the company were to become a member of the—

Senator BROOKE. Federal guarantee member, yes.

Mr. KINDER. Yes, and it would have to meet the requirements that are otherwise set out, but there would be no requirement that it be covered.

Senator BROOKE. Well, they could opt, but they would have to go one way or the other. I am told that my 10 minutes is up, but I will come back. I have further questions.

The CHAIRMAN. Senator Schmitt.

Senator SCHMITT. Thank you, Mr. Chairman.

Again, I wish to join with you in complimenting Senator Brooke for introducing this bill and bringing to our attention an area that at least I, as a new member of the committee, have not had a chance to examine before and try to understand.

I am concerned about individuals—very much concerned about individuals who may, through no fault of their own, suddenly find them-

selves without an insurance policy and having lost everything that they invested in that policy and I'm sure the gentlemen at the witness table are equally concerned about this or they would not be involved in the business.

I'm curious about a number of things. Mr. Stone, how would you envision a bill such as this, taking into account the differences between the insurance environment of New Mexico versus that of Massachusetts, which have quite different geographic situations? The life styles and the economies are very, very different between those two States and, of course, I just picked those as examples since you're from Massachusetts and I'm from New Mexico. There are many other examples. How would you see the Federal Government begin to get deeply involved in the regulation of insuring that those differences are taken into account? Generally, they have not been where the Federal Government has gotten involved. Regional differences have caused many, if not most, of our difficulties in the use of Federal regulation.

Mr. STONE. In my earlier statement I tried to break down the work of the department into three areas. I think that with respect to the solvency area there really isn't a great need to take into account regional differences. You want companies to be solvent and pay their claims whatever the State may be, and that's the area that the bill addresses. I think that is an interstate, national problem for nationally operating insurers and I guess I really don't see a great regional problem there.

In the area of monitoring business practices, there are certainly great regional differences as to what's considered acceptable business practice, but the bill leaves that to the various States and so I don't think that, again, there would be that problem of coordination.

Where I think the problem arises is in rate regulation. That's where the disparity between various States is most important and that's the area of the bill that I would suggest be subject to some rethinking. That's a very complicated subject, determining what constitutes the right kind of rate regulation, whether thinking in national terms or on a regional basis.

So I feel comfortable with the solvency pieces, the guarantee fund pieces, the examination pieces of the bill because I don't think there need be any regional disparity there.

Senator SCHMITT. Would any other member of the panel care to comment? You don't have to.

Mr. MATHIAS. I think we are very concerned about the geographical variation that could occur and there is language that perhaps could be corrected by technical amendments but which would indicate that the Federal Commission may have more authority than has been suggested concerning the conduct of insurers other than their financial examination.

Senator SCHMITT. If I understand, Mr. Mathias, your concern is that you think this is a foot in the door where it would lead to great regulation and so forth. Is that correct?

Mr. MATHIAS. Well, I think that's a concern. I think the other concern is just whether or not the entire necessity for a new Federal structure has been shown to date and I sincerely question whether that has been done.

Senator SCHMITT. Are any of you gentlemen—and I will initially direct this to Mr. Kinder—aware of any thought within the private sector of the insurance sector to establish privately financed and funded reinsurance programs to protect against insolvencies? Has that been discussed and, if so, has it been rejected out of hand or has there been serious discussion that this is an alternative to a federally guaranteed fund?

Mr. KINDER. There is one concept being explored along that line that hasn't been fully developed, Senator. I think there are groups of people looking at that potential.

Senator SCHMITT. Is there any particular form that this takes, philosophical or—

Mr. KINDER. In effect, I think it would be using the insurance mechanism to accomplish the purpose, in effect creating solvency insurance and making it available to insurers, charging them a price for that.

Senator SCHMITT. Do you see there being a great incentive for someone like one of these firms that's been mentioned having gone insolvent being a member of that? Is it an offer they can't refuse?

Mr. KINDER. In a competitive environment where the consequences of insolvency are known to the buyer, I think there is, simply in advertising the fact that you have that available for the protection of your policyholders.

Senator SCHMITT. Would you expect such a reinsurance concept to be stimulated now by the introduction of this bill?

Mr. KINDER. I think that it would result in some further discussion. Whether I would characterize it as stimulation or not, I'm not sure I would be that strong.

Senator SCHMITT. Mr. Stone, do you have any estimate of the—you may just pick your own State if you wish—of the numbers of State auditors that you can see being replaced by Federal auditors? You seem to think that the fact that the State cannot pay auditors as much as is necessary to get the quality of personnel that's required, that this somehow would be relieved by Federal activity. Do you know approximately the percentage or the number of people in the State of Massachusetts which the State would no longer have to employ?

Mr. STONE. No. That would be hard for me to estimate at this point. We have cut down on the number of auditors in our department over the last few years and I suspect that there will be some continued cutting.

Senator SCHMITT. Excuse me if I may interrupt. Is this so you can increase salaries and quality of the personnel you have or is this because of general budgetary policy?

Mr. STONE. Our total budget has remained about the same and we have cut down the number of personnel and tried to upgrade the professional caliber of the personnel both in this area and in the rate regulation area.

Senator SCHMITT. What has been your experience? Has this improved the quality of service that your office has been able to provide?

Mr. STONE. Yes, I think it has. That's very hard for me to measure. I have some bias on the subject, but I think it has. It would be hard for me to estimate the savings. I would say that right now we are trying

to devote about half of our examination personnel's time to market conduct examinations which concern business practices. That presumably would be maintained. I'm not sure how much of the other half we could cut back if there were Federal regulation. That would depend on exactly how good Federal regulation was and how comfortable we were with their work.

Senator SCHMITT. Do you see any way to make an estimate at this time before passage of the bill?

Mr. STONE. I really don't. One of the things that insurance commissioners learn very early is to be very wary of making estimates. They always appear in the newspapers and commissioners always get stuck with them. So I'm afraid to make an estimate at this time.

Senator SCHMITT. Finally, we've gotten in this country very familiar and comfortable, if you will, with the FDIC concept, Federal Depository Insurance Corporation. Do you see an FDIC concept—I'm not as familiar with the legislation as I should be—coming out of this legislation as sort of that kind of idea, if I interpret it correct? Do you see that as something the country may become comfortable with? **Mr. Mathias**, do you want to comment?

Mr. MATHIAS. As to whether I see it coming out of this particular bill, I would hesitate to guess, but obviously by the content of the testimony today I would prefer not.

Let me, if I may, just go back to a point that was touched upon by my fellow commissioner, and that is if a Federal regulatory agency is established the impact that that would have on State regulation. That is, if we want to recruit, where do you go to recruit? Probably to many of the State regulatory agencies. Therefore, it almost becomes a self-fulfilling prophecy that we will have Federal regulation that will be using many of the former regulators, many of the chief examiners, and so forth of State insurance departments; and that, again, as far as—I hate to be pragmatic in these things, but that's one of the pragmatic concerns that we have.

Senator BROOKE. **Mr. Mathias**, couldn't you go to the insurance companies and CPA firms?

Mr. MATHIAS. Excuse me?

Senator BROOKE. I think you could recruit from insurance companies and CPA firms and get personnel.

Mr. MATHIAS. I'm sure that can be done. Although **Mr. Stone** and I happen to be perhaps on opposite sides of this issue, I think we have been cooperating extensively in the CPA audits of insurance companies, and I haven't talked to the commissioner from your State, but I think that we would be in agreement that sometimes we have been surprised at the type of work product that we have received from some CPA firms. They may not be the bacchanalia that we thought they were.

Senator SCHMITT. Would you care to offer—any of you—and let me begin with **Mr. Kinder**—some way of solving the problem of this surplus—I believe you call it surplus insurance company where a company sells without being authorized to sell in a State?

Mr. KINDER. There are several ways in which this could be achieved I believe. One of the things that poses a bit of a problem is the way

the guarantee associations work. Those companies that are admitted to do business in the State are assessed to pick up the consequences of insolvency. There have been no assessments levied against nonadmitted carriers. So they are not paying for the cost of the insolvencies.

Senator SCHMITT. What allows them to do business if they are not admitted? Why are they not violating State law?

Mr. KINDER. Well, I guess it's the constitutional right of the policyholder to buy his insurance wherever he wants to buy it. There's nothing to preclude a man from going out of State to purchase his insurance from a nonadmitted carrier.

If it's done within State, most States have laws governing the way in which that can be handled and it must be done through what are identified as surplus lines brokers and I would submit that the policyholder has a potential claim against the surplus lines broker who has placed insurance in a nonadmitted carrier that may become insolvent. So there is one avenue of potential recovery for the uninsured policyholder or, that is, the policyholder of a defunct nonadmitted carrier.

Senator SCHMITT. Does your State license a surplus line broker?

Mr. KINDER. Yes, sir.

Senator SCHMITT. Have you ever considered bonding them in some way?

Mr. KINDER. We bond them as well.

Senator SCHMITT. You do?

Mr. KINDER. Yes; but the amount of the bond is nominal I believe. It has only recently been raised to \$100,000.

Senator SCHMITT. Do you see a possible mechanism by which, say the State of California could provide for insolvency funds even for the surplus line insurer?

Mr. KINDER. Yes, sir. I think there are several ways that could be accomplished. One could do it on a preassessment basis by adding some increment to the surplus lines tax that is added on to whatever premium the nonadmitted carrier charges. On a postassessment basis any companies doing business through surplus line brokers could be assessed through that device in the same fashion that admitted carriers are in the State.

Senator SCHMITT. Thank you.

Senator BROOKE. Would the Senator yield?

Senator SCHMITT. Sure. My time is up.

Senator BROOKE. Just on the surplus lines issue, the product liability and malpractice crises have created quite a problem because many States can't take care of their institution needs through licensed companies and therefore they let nonadmitted companies come into the State to take up that slack. I presume that's what your problem has been, has it not, in California?

Mr. KINDER. Yes. We have had a sharp increase in the amount of business written in nonadmitted carriers. I think the 1976 premiums were almost double the premiums of the immediate prior year. However, it is a very small part of total premium. I believe our surplus lines premiums in California last year were about \$150 million. Our aggregate property liability insurance premiums in California were in excess of \$7 billion. So it's a minuscule part of the total.

The CHAIRMAN. Mr. Kinder, the issue that Senator Brooke raised so well—I'm talking about All Star and Empire and so forth—their

surplus insurance problem and with the fact that the policyholders have no recourse, you started to reply to that by pointing out that S. 1710 in your view would not be the best answer to it. You seem to imply that, for one thing, the companies that would be covered would volunteer to go for the Federal charter and there's no indication that All Star, Empire, and companies like that would have done so.

There's also the question of whether or not they would qualify for the Federal guarantee fund. On page 19, after line 14, it says:

The Commission may refuse to issue a certificate hereunder upon its determination that the insurer is not financially safe and sound for any, or any combination, of the following reasons:

(i) assets supportive of the insurer's policyholder obligations fail to provide sufficient integrity and stability for that purpose;

(ii) the insurer's underwriting commitments have consistently been in excess of its capacity;

(iii) in applying for the certificate, the insurer has failed to disclose material facts or circumstances bearing upon its worthiness for receiving a certificate;

(iv) the insurer's reserves for liabilities are materially deficient or its liabilities are materially understated;

(v) the insurer is effectively controlled by officers, directors, stockholders, or other persons whose conduct has demonstrated such persons to be unworthy of trust or confidence.

Now I presume that these companies that were unable to meet their policyholders' obligations might have been disqualified on one of those four requirements and therefore not have qualified for the Federal guarantee fund. Is that right?

Mr. KINDER. I would assume so.

The CHAIRMAN. In that event, I would assume that this option would not be one that would cure or correct the problem we have involved here. Is that your view?

Mr. KINDER. That's my view; yes.

The CHAIRMAN. Mr. Stone, what is your response to that?

Mr. STONE. Yes; I think that's possible, as the bill is drafted now.

The CHAIRMAN. Isn't it likely? Isn't it likely that you would not get the more or less weak insurance companies to take this option and to qualify?

Mr. STONE. Yes; I think that's likely, as the bill is drafted now. I think that some of the people who have spoken on the bill seem to oppose it because they fear that it's the thin edge of a wedge of growing Federal regulation.

The CHAIRMAN. Can't it be exactly that? Let me just interrupt to say what concerns me a great deal, and I think what must concern you and the industry, is that we might move toward Federal preemption with this kind of legislation. In other words, strong insurance companies might decide that they can qualify here if they want to get away from the mix of regulation they have. They might go Federal.

Senator BROOKE. It hasn't happened in banking.

The CHAIRMAN. In which case, if you did that, wouldn't you then have a situation where in order to protect those who were insured by those who were chartered by the State the Federal Government might just have to preempt and wipe out the State regulation?

Senator BROOKE. It hasn't happened under the dual banking system.

The CHAIRMAN. As Mr. Kinder pointed out, there are some pretty sharp differences.

Senator BROOKS. I don't think there are.

Mr. MATHIAS. There's only one FDIC. It's at the Federal level, not the State.

The CHAIRMAN. Let me ask Mr. Stone to reply to my question.

Mr. STONE. Let me say I probably don't share the majority view in that I am not afraid that this is the thin edge of the wedge. I favor the thick edge of the wedge. I'm not afraid to see—

The CHAIRMAN. What's the thick edge of the wedge?

Mr. STONE. Increasing Federal involvement to the point that insolvency protection and examinations might be the exclusive domain of the Federal Government. I think that would not be a bad system and, as I said earlier, the only questions in my mind arise about whether the Federal Government is the appropriate place to regulate the business practices or the rates.

The CHAIRMAN. Maybe the cat's out of the bag now. You say the Federal Government should move in to eliminate this danger of loss, in effect, and if that is done, don't you have then indeed a big, enormous Federal liability and necessarily a big Federal bureaucracy and much higher cost of regulation within a demonstrable showing so far, it seems to me, that there have been sufficient losses to warrant that kind of increased costs?

Mr. STONE. Well, if you're talking now about the ultimate thick edge of the wedge, as I call it, then I think that most of the State examination function could ultimately be superseded and that solvency and financial examination could be exclusively the domain of the Federal Government. I believe this would be substantially cheaper than having 50 States perform it each separately.

The CHAIRMAN. Well, in view of the fact that the insurance companies—I hesitate to quote such an obvious authority—but the head of the Office of Management and Budget has said if it's not broke, don't fix it; and while I might disagree with Mr. Lance along with a few others, being the only Senator to vote against his confirmation, I think he's got a pretty good principle there.

Here we have a situation where we don't have a crying out on the part of policyholders around the country or others like you who have this responsibility. You seem to be almost alone among insurance commissioners asking for this. I can't understand why we should move in with a Federal program.

Mr. STONE. Well, if efficiency alone rather than the avoidance of disaster is a good criteria, then I think that we ought to move toward Federal regulation. But, in addition, if there is ever a major life insolvency, then you will have the kind of disaster that you're looking for. If we have a major life company go under, you will find that very few of their policyholders will be protected and the State systems are not well prepared either to prevent that or to make the policyholders whole when that occurs. I don't think that's likely very soon though.

The CHAIRMAN. We have been operating for a long time in this country without Federal regulation with State regulation and we have gone through terrific depressions, depressions people argue we aren't likely to go through again because we have so many safeguards. At any rate, we haven't come close to this disaster. Why would we expect now to have that come up in view of the fact that it never has?

Mr. STONE. I don't think we are in clear and present danger, but I do think you would have a more efficient system of regulation for solvency if it were at the Federal level and you remove this danger which, although it may not be a clear and present danger, is still there.

The CHAIRMAN. Do you believe, like a lot of people, that the Federal Government is more efficient than the States?

Mr. STONE. I think that is an important premise in my thinking. I do think that the Federal Government would handle the job more efficiently, more competently, and also would be free from what I think is some undue influence that occurs at the State level more easily than it would occur at the Federal level.

Mr. KINDER. Yes, I do.

Senator BROOKE. One is: What data does your organization keep or have available to it regarding the number of insurance company impairments and insolvencies and related problems?

Mr. KINDER. We retain a list of insurance company insolvencies and impairments and the annual statements filed with our statistical reporting system going back 5 years are also retained and the record of insolvencies are used to evaluate the effectiveness of the early warning system. The McKinsey study and other studies of the early warning system available to the NAIC will be reproduced and furnished to this committee for inclusion in the record.

Senator BROOKE. You will supply for the committee's record any studies that you have commissioned which are available to you on the subject of insolvencies?

Mr. KINDER. Yes, sir.

[The following was ordered inserted in the record:]

U.S. SENATE,
Washington, D.C., August 29, 1977.

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS,
Milwaukee, Wis.

(Attention Richard Hemmings, Counsel)

GENTLEMEN: The Senate Committee on Banking, Housing, and Urban Affairs will hold hearings on S. 1710, to authorize the issuance of charters for carrying on the business of insurance, to provide for the guarantee of the insurance obligations, and for other purposes, on September 12-14, 1977. This bill provides a Federal chartering alternative for insurance companies and establishes a Federal Insurance Guaranty Fund to protect insurance company policyholders. A copy of the bill and Senator Brooke's remarks at the time of introduction are attached.

This will confirm your appearance to testify before the Committee regarding S. 1710. Your appearance is scheduled for Tuesday, September 13, 1977.

Without wishing to impose any constraints on your oral testimony, the Committee would appreciate it if your written testimony addressed the following questions:

1. What data does your organization keep (or have availability to it) regarding the number and extent of insurance company impairments, insolvencies, and related problems? Please supply for the Committee's record any studies which you have commissioned or which are available to you on the subject of insolvencies (including studies prepared by McKinsey and Co.).

2. Is there a nationally recognized definition of what constitutes an insurance company insolvency? Has your organization developed or proposed such a standard?

3. How many of the insurance company insolvencies which have occurred since 1970 have not been covered by state guaranty funds and what is the extent of losses to policyholders and claimants of these failed companies?

4. To what extent have policyholders of insolvent companies covered by state guaranty funds or their claimants not been compensated for losses due to the deductibles and maximum recovery limits imposed by state guaranty plans?

5. In the event of the insolvency of a major company, what procedures have been developed for distributing the assets of such a company among the guaranty funds in the states in which the company was doing business?

6. In most states both property-liability and life and health guaranty funds have been proposed in approximately the same time frame. To date our information indicates that only 17 states have adopted life and health guaranty laws whereas 48 states have property-liability guaranty laws. Why has the adoption of life and health guaranty laws lagged so far behind adoption of property-liability laws?

7. In an article by Jack H. Blaine appearing in the Spring, 1977 edition of *Forum*, state guaranty plans seem to be plagued by constitutional and other legal problems. Could these serious and continuing legal difficulties compromise the effectiveness of state guaranty funds?

Hearings will commence at 9:30 a.m. in Room 5302, Dirksen Senate Office Building. I would request that 75 copies of your testimony be made available to the Committee no later than 9:30 a.m. on Friday, September 9, 1977. I would appreciate your limiting your oral presentation to not more than 10 minutes. Your written statement will, of course, be printed in full in the hearing record.

If you have any questions, please telephone Jeremiah S. Buckley of our Committee staff at 202-224-7891.

Sincerely yours,

WILLIAM PROXMIER, *Chairman.*

STATE OF CALIFORNIA

EDWARD G. BREWER & COMPANY

DEPARTMENT OF INSURANCE

900 SOUTH BROADWAY AVENUE
LOS ANGELES, CALIFORNIA 90001

(213) 736-2572

November 30, 1977

Honorable Lillian Prentiss
Chairman, Senate Banking Committee
Washington, D.C.

Dear Senator Prentiss:

During the course of my appearance before the Banking Committee on September 1, 1977, on S. 1710, I was asked to provide additional information on insurance company insolvency and related matters for inclusion in the record. The question is answered below.

1. What data is the State of California keeping for the purpose of determining the number and extent of insurance company insolvencies? The data is maintained in the Insurance Department's files on the insolvency of insurance companies. The data is maintained on a continuing basis and is available to the public upon request.

We are providing by separate letter confidential information on the state of insurance companies that have experienced financial difficulties since or after January 1, 1977. In addition, we have also provided information on developments by other states, including the Federal Reserve Board's study of the year 1963-64. The McKimsey study of the early 1960s and explanatory materials for the system are enclosed.

2. How many of the insurance companies in California have failed since 1970? There have been two failures since 1970. The first failure was in 1971 and the second failure was in 1972.

Since the insurance companies do business in California, they are subject to the supervision of the Insurance Department. The Department is responsible for the supervision of the insurance companies and for the protection of the policyholders. The Department is also responsible for the regulation of the insurance industry. The Department is currently reviewing the insurance industry and is expected to report to the Legislature in the near future.

* Retained in Committee files.

In order to answer whether a given insurer insolvency occurring since 1970 was covered under state guaranty fund laws, it would be necessary to determine in what states the insurer was doing business and whether those states at the time of insolvency had an operative guaranty fund. Policyholders of a particular insurer would have guaranty fund protection only in those states with guaranty fund laws, policyholders located elsewhere without such funds would not in most situations. The operative dates of property-casualty state guaranty funds are:

Alaska	8/6/70
Arizona	8/27/77
Arizona	3/30/77
California	8/31/69
Colorado	7/1/71
Connecticut	10/1/71
Delaware	7/1/70
District of Columbia	8/14/73
Florida	10/1/70
Georgia	7/1/70
Hawaii	5/25/71
Idaho	5/6/70
Illinois	7/21/71
Indiana	6/1/72
Louisiana	7/1/70
Kansas	Upon Publication
Kentucky	6/15/72
Louisiana	9/1/70
Maine	5/9/70
Maryland	7/1/71
Massachusetts	1/1/71
Michigan	8/11/69
Minnesota	7/1/71
Mississippi	4/6/70
Missouri	9/13/71
Montana	7/1/71
Nebraska	5/26/71
Nevada	5/5/71
New Hampshire	5/4/70
New Jersey	5/11/74 Post-Assessment (Preassessment previously in effect)
New York	Preassessment 1947, amended 1969
New Mexico	4/4/73
North Carolina	6/25/71
North Dakota	7/1/71
Ohio	9/4/70
Oregon	9/9/71
Pennsylvania	11/25/70
Puerto Rico	7/3/74
Rhode Island	5/7/70
South Carolina	6/25/71
South Dakota	7/1/70

Tennessee	7/1/71
Texas	5/25/71
Utah	3/11/71
Vermont	7/1/70
Virginia	6/25/70
Washington	5/21/71
West Virginia	5/12/70
Wisconsin	6/22/69
Wyoming	2/27/71

As can be seen, the vast majority of states enacted their laws in 1970-71, resulting in guaranty fund protection in nearly all states at that time. Relatively few property-casualty policyholders were unprotected by guaranty fund laws by 1972. More important, however, is the present extent of guaranty fund protection which, as noted, exists in all but two states.

Due to the length of time in settling the affairs of an insolvent insurer (which may occasionally take up to ten or more years), it would be difficult to develop data on losses to policyholders since 1970 in states without guaranty fund laws. Such information is not currently held by or available to the NAIC nor could it be produced on a nationwide basis without considerable time and expense.

Liquidators begin distributing dividends or paying claims after liabilities are determined and assets are untraveled. Even without guaranty fund protections, policyholders or claimants may recover part or substantially all of their claims as general creditors.

3. To what extent have policyholders of insolvent companies covered by state guaranty funds or their claimants not been compensated for losses due to the deductibles and maximum recovery limits imposed by state guaranty plans?

As discussed during my appearance, the NAIC model guaranty fund acts and most state laws provide deductibles, typically \$100 or \$200, to the amount which guaranty funds are obligated to pay. Deductibles in the funds may cause a consumer loss sharing on covered claims. Similarly, the NAIC model bills provide maximum recovery limits of \$300,000 and also pose the possibility of loss sharing on a covered claim. These limitations represent the NAIC's determination of practical limits to guaranty fund obligations that balance the interest in minimizing the cost of the guaranty versus providing substantial protection. Various arguments can be advanced in favor of enriching and diminishing the guaranty coverage. In any event, however, the costs of guaranty fund coverage are borne by policyholders.

Despite the existence of maximum recovery limits and deductibles, policyholders may, nevertheless, recover from an insolvent insurer portions of a claim not

paid by the guaranty system because of these limits. To the extent the policy obligates the insurer for coverage in excess of the maximum recovery under the guaranty fund law or coverage of the guaranty fund deductible amount, the policyholder is a general creditor of the failed insurer entitled to pro rata payment upon liquidation.

The NAIC does not have available to it aggregate figures for policyholder losses attributable to deductibles and maximum recovery limits. Again, the length of time involved in settling the affairs of insurers would compound the task of compiling total losses to policyholders determined after the insurer is liquidated.

However, it is clear that claims in excess of other maximum recovery limits under the guaranty funds are as should be expected, except small. New York, for example, with a \$1 million limit on its property-casualty security fund, has never had a claim in excess of the limit. California similarly, with a \$500,000 maximum recovery limit in its property-casualty guaranty fund, has had no claims in excess of its limit.

Part of the rationale in including deductibles in the guaranty fund coverage is to minimize costs which are assessed, in effect, to policyholders of other insurers. Policyholders of insolvent insurers, by way of the deductibles, bear some of the financial consequences of selecting the insurer that becomes insolvent. We do not believe that the deductible significantly diminishes the broad protection afforded by the guaranty fund, while at some time it allows the economical operation of the fund.

4. *In an article by Jack H. Blaine appearing in the Spring 1977 edition of Forum, state guaranty plans seem to be plagued by constitutional and other legal problems. Could these serious and continuing legal difficulties compromise the effectiveness of state guaranty funds?*

We do not agree that Mr. Blaine's article raises "serious and continuing legal difficulties." The issue of retroactivity discussed in that article will obviously be self-eliminating after a period of time. This is not in any way a continuing legal problem that can threaten the viability of the state systems, but rather raises questions on a state-by-state basis of application to past, not future, circumstances.

As far as constitutional issues are concerned, it has long been recognized that the insurance business vitally affects the public interest (Gutman v. Allien & Ins. Co. v. Lewis, 232 U.S. 389 (1914)). In deciding various due process issues, the Supreme Court in 1951 upheld a California assigned risk plan and recognized that in the insurance field, "the power of the state is broad enough to take over the whole business, leaving no part for private enterprise" because of the affected public interest (California Auto Assn. v. Maloney, 341 U.S. 103, 110 (1951)). More directly, in Maloney the court

recognized the similarity of the California assigned risk plan under which insurers equally share bad risks to a guaranty fund. The court relied on Maloney in its decision in Noble State Bank v. Haskell (219 U.S. 104 (1911)), which sustained a state law assessing each state bank for the creation of a depositor guaranty fund (Maloney at 109). These decisions leave virtually no doubt as to the power of the state to mandate insurers' participation in insurance guaranty funds.

Other than the Arizona Supreme Court decision that a previous Arizona Guaranty Fund bill was unconstitutional (because it was created by "special law"), no state law has had its guaranty fund law declared unconstitutional. The Arizona case, Firemans Fund Insurance Co. v. Arizona Insurance Guaranty Association (536 P.2d 895), was decided on a narrow issue, and that act has since been replaced by an act that was drafted to overcome the prior constitutional infirmity. There is virtually no basis for suggesting that the constitutionality of state guaranty fund laws has been cast in doubt by legal challenges.

Specifically, the cases noted in Mr. Blaine's Forum article do not give rise to reasonable concerns over the viability of state funds. O'Malley v. Fla. Ins. Guaranty Ass'n. (257 So.2d 9 (Fla. 1971)) upheld the constitutionality of the Florida law, and the U.S. Supreme Court denied certiorari despite a plea that the decision had constitutional implications in other states.

The Iowa decision, Osborne v. Edison (211 N.W. 2d 696 (Iowa 1973)), was not a challenge of the Iowa act but rather determined the meaning of language contained in the act. Judicial clarification of statutory language is hardly unique to the states nor is it unexpected.

The Washington decision, Actna v. Washington Life and Disability Insurance Guaranty Association (520 P.2d 161 (1974)), upheld the constitutionality of the Washington statute. According to the Washington Supreme Court, differences in treatment of foreign and domestic insurers did not render the Washington act unconstitutional since there was a rational basis for such differences.

A review of these and other challenges of state guaranty funds does not in any way support the contention that state guaranty fund laws are plagued by legal difficulties. To the contrary, it is abundantly clear that such enactments are lawful and proper state controls over the insurance business and insolvency problems.

Sincerely,


WESLEY J. KINDER
Insurance Commissioner

WJK:hp
Encls.

USING THE EARLY WARNING SYSTEM

NAIC Audit Ratios for
Property and Liability Companies
1973

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Appendices

A - Audit Ratio Work Sheets

B - Recent Improvements in the Early Warning System

1 - HOW THE EARLY WARNING SYSTEM WORKS

The NAIC Early Warning System, developed by a committee of state insurance regulators, is intended to assist the various state Insurance Departments in identifying property and liability insurance companies requiring particularly close surveillance. The system is based on eleven audit ratios, or tests, which have been shown to be effective in distinguishing between financially troubled and sound companies.

This chapter describes the purposes of the Early Warning System, the method of identifying priority companies, and the reports provided by the system.

PURPOSES OF THE SYSTEM

The purposes of the Early Warning System are to help state Insurance Department personnel quickly identify companies requiring close surveillance and determine the form that surveillance should take. The system is not intended to replace in-depth financial analysis or on-site examination of companies. It can, however, provide a guide to those companies for which deeper analysis may be required. It can also serve as an aid in determining which companies may require special on-site examinations, either to resolve specific issues or to verify overall financial solidity.

Although the system has been shown to be effective in distinguishing between troubled and sound companies (as discussed below), it is by no means foolproof. This fact has two important implications:

1. No state should rely completely on the Early Warning System as its only form of surveillance.
2. Important decisions, such as decisions on policy rates, should not be based on the results of the tests. However, a company which is in a "troubled" category may require closer surveillance.

SELECTION OF PRIORITY COMPANIES

By comparing the test results for all companies in 1972 with the results for companies becoming insolvent during the past five years, a "usual range" of test results has been determined for each of the individual audit ratios. Companies falling outside this usual range on four or more of the eleven tests (not including the one-year version of the operating ratio) are treated as priority companies. Companies falling outside the usual range on no more than three tests are treated as nonpriority companies.

Nationwide, between 10 and 15 percent of the companies tested are expected to receive the priority company designation. These are the companies most likely to require closer than usual monitoring by the Insurance Department. Their test results should be verified, and further analysis of their annual statements should be performed to determine whether an on-site examination is called for.

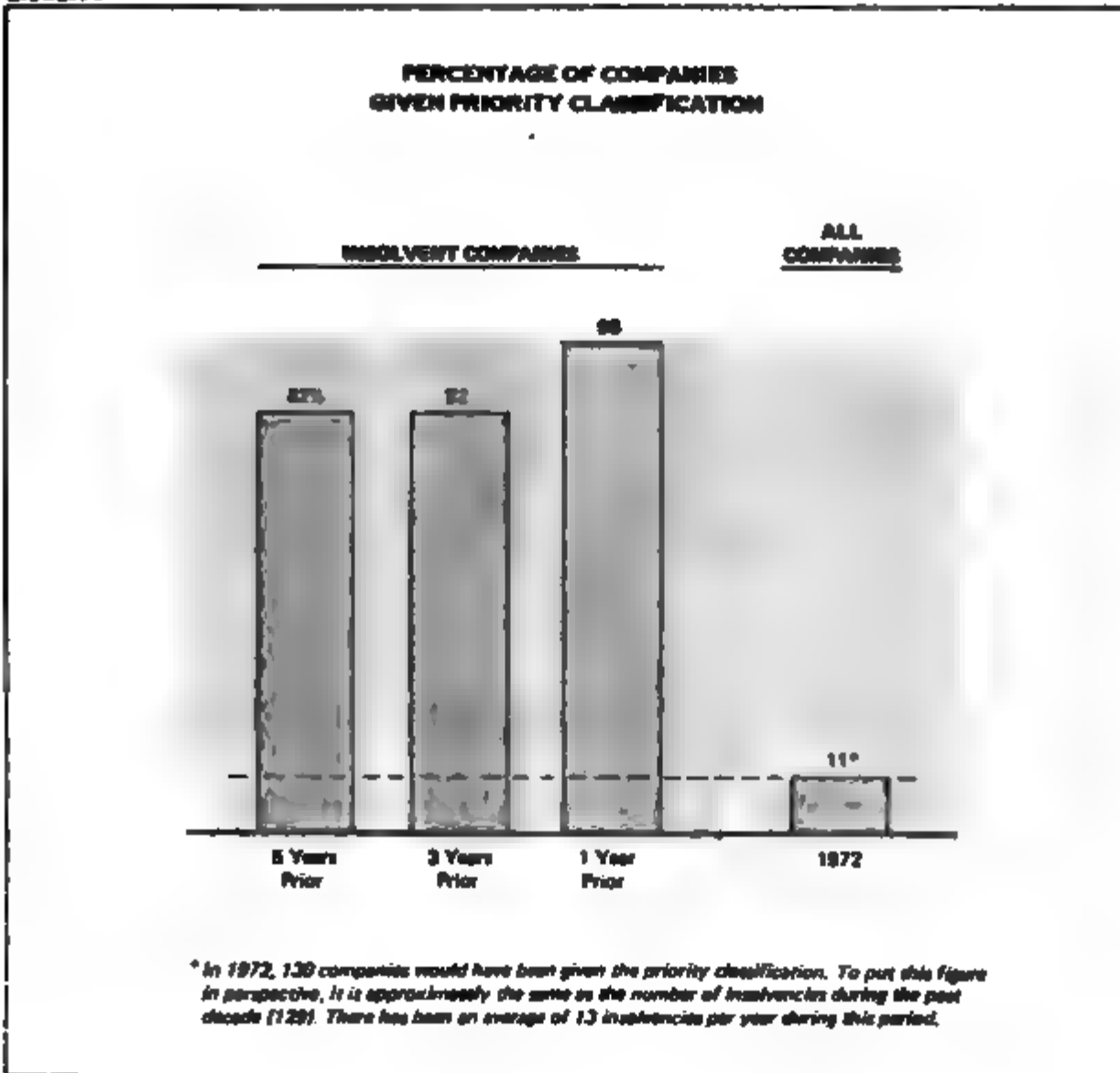
Although the intent of the priority company system is to assist Insurance Department personnel in focusing their immediate attention on those companies most likely to be experiencing financial difficulty, not all the priority companies will necessarily be troubled. Some may have taken action to eliminate weaknesses that became apparent during the prior year. It is also possible that unusual accounting methods may make test results appear less favorable than is warranted, or that errors may occur in calculating test results. However, unless a given priority company is known to be financially sound, careful analysis and examination of that company would be appropriate.

Nonpriority companies are less likely to require in-depth review or on-site examination. However, the fact that a company is not given the priority classification by the Early Warning System should not be taken as a guarantee of continuing financial solidity. The results of individual tests for each nonpriority company should be carefully analyzed. If areas of concern are identified, a review of that company's annual statement should be made to determine whether an examination is required.

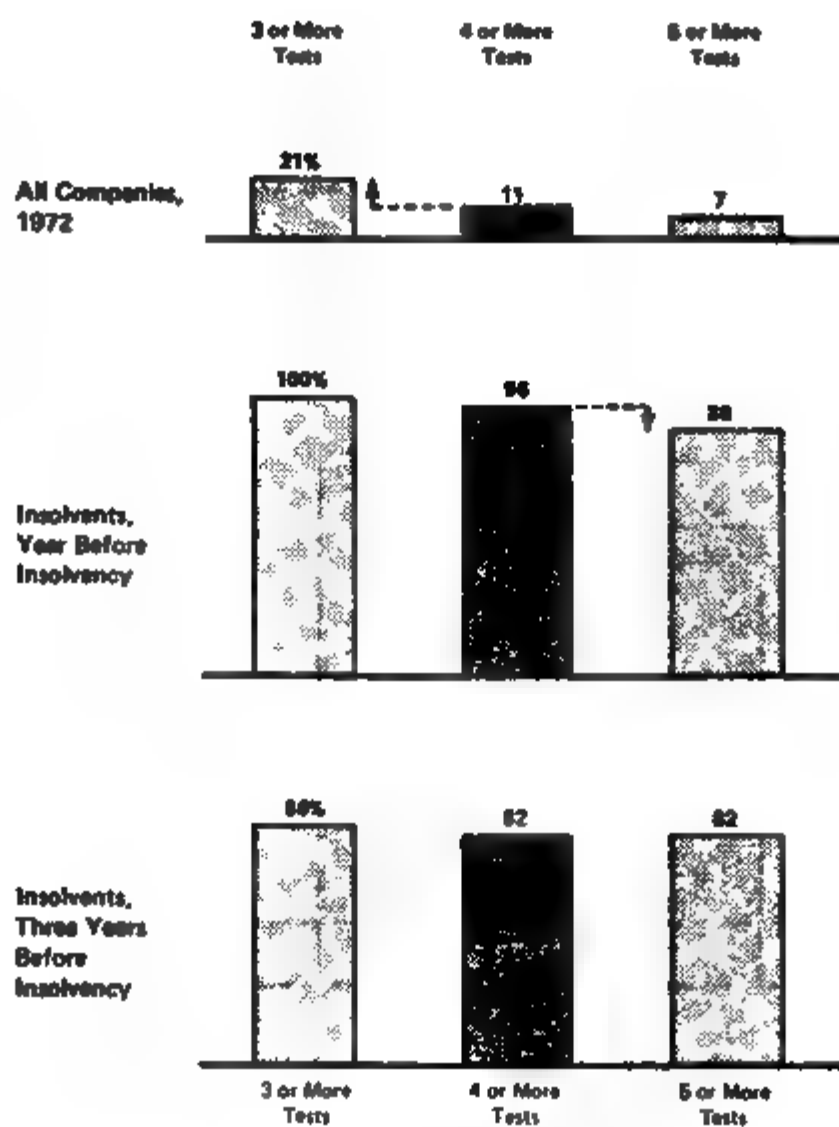
Over the past half decade, more than 80 percent of the insolvent companies whose annual statements were available for three years before insolvency would have been classified by this system as priority companies, half of those not so classified experienced changes in ownership or control during their last three years. All but one of the insolvent companies studied would have been given the priority classification in their final year. The one

exception was a company that had been clearly identified five years before insolvency (seven tests outside the usual range) and three years before insolvency (nine tests outside the usual range), but which fell outside the usual range on only three tests in its final year, when operations had come under close control by the Insurance Department. Exhibit I shows the percentage of companies becoming insolvent in the past five years and the percentage of all companies in 1972 that would have been given the priority classification under the four-of-eleven rule.

EXHIBIT I



PERCENTAGE OF COMPANIES FALLING
OUTSIDE THE USUAL RANGE ON



The four-of-eleven rule proved to be the most effective and easiest to use of a variety of potential methods of selecting priority companies. Exhibit II compares the effectiveness of the four-test rule with that of three- and five-test rules for selecting priority companies. If all companies falling outside the usual range on three or more tests were placed in the priority group, the percentage of companies so classified would almost double, but the percentage of actual insolvents identified would increase only slightly. On the other hand, if the priority group were to include only those companies falling outside the usual range on five or more tests, the percentage of soon-to-be insolvent companies rightly identified in the final year would drop from 96 percent to 88 percent.

Another possible approach would be to select priority companies on the basis of results on a few key ratios. However, no combination of a few tests proved as effective as using all eleven tests.

A final approach tested involved assigning from one to five points for each test outside the usual range, depending on the amount. This approach would be almost as effective as the chosen system, but would be more difficult to use and interpret.

EARLY WARNING REPORTS

Each state will be provided with three types of reports from the Early Warning System:

1. Summary Releases
2. Priority Company Data Sheets
3. Wrap-up Report.

Summary Releases

Periodically, as test results become available, each state will receive Summary Releases showing test results for those companies and groups of companies domiciled or licensed in that state. The first Summary Release for this state is included in this binder, under the tab "Summary Releases." Future releases should be inserted under this tab as they are received.

The purpose of these Summary Releases is to provide an overview of test results for all companies and to identify the priority companies. In each Summary Release, priority companies are listed first, followed by non-priority companies. Within each group, domestic and foreign companies are listed separately. Test results falling outside the usual range are indicated by an asterisk.

Test results for companies that are not domiciled or licensed to do business in the state are not included in the Summary Releases, but will be available in the annual Wrap-up Report, discussed below.

Priority Company Data Sheets

The purpose of the Priority Company Data Sheet is to assist in further analysis of the financial condition of priority companies. For each priority company, the data sheet provides:

1. Test results for the past three years
2. A breakdown of four of the more complex ratios into their component parts
3. Key annual statement data for the current year.

Suggestions regarding the interpretation of test results and for performing further analysis of the annual statement can be found in the second chapter of this report, beginning on page 7.

The data sheet for each priority company will be received together with the Summary Release in which that company is included. Data sheets for the priority companies included in the first Summary Release will be found in this binder under the tab "Priority Company Data Sheets." Data sheets received in future releases can be inserted under that tab in alphabetical order for future reference.

Wrap-up Report

When the test results for substantially all of the companies have been calculated each year, a final Wrap-up Report will be issued. The purpose of this report is to provide a reference containing test results for all companies and groups or fleets. Companies will be listed in alphabetical order, with priority companies identified by a "P" before the company name. The states where each company is domiciled and licensed will also be indicated. Otherwise, the Wrap-up Report will be in the same format as the Summary Releases.

II - THE AUDIT RATIOS

This chapter describes the eleven audit ratios and provides suggestions for interpreting test results and determining the types of further analysis needed. The audit ratios fall into four groups:

- 5 Overall tests
- 9 Profitability tests
- 5 Liquidity tests
- 5 Reserve tests.

Work sheets, which can be copied as needed for manual calculation of test results, will be found in Appendix A. These work sheets may also be useful in clarifying the details of how the ratios are calculated.

For all tests except investment yield, results are rounded to the nearest percent and limited to the range from minus 99 percent to 999 percent. For investment yield (Test 5), results are rounded to the nearest tenth of one percent and limited to the range from zero to 9.9 percent.

EXHIBIT III

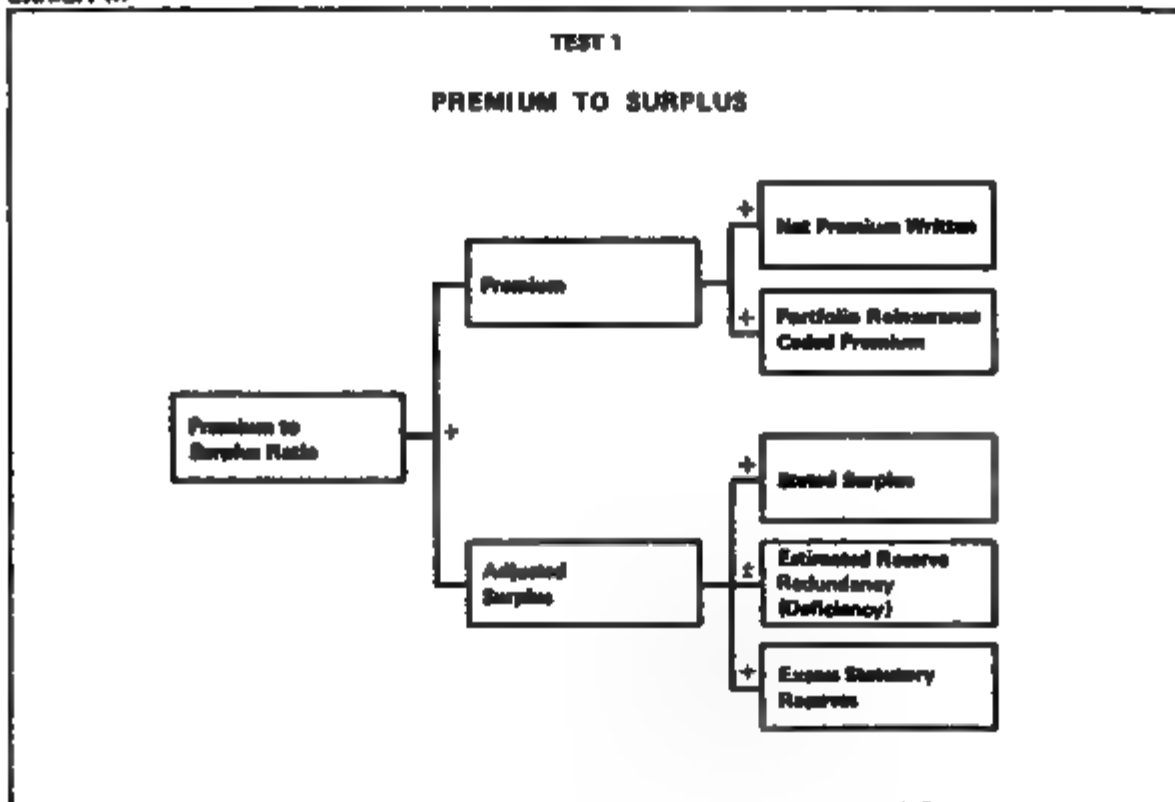
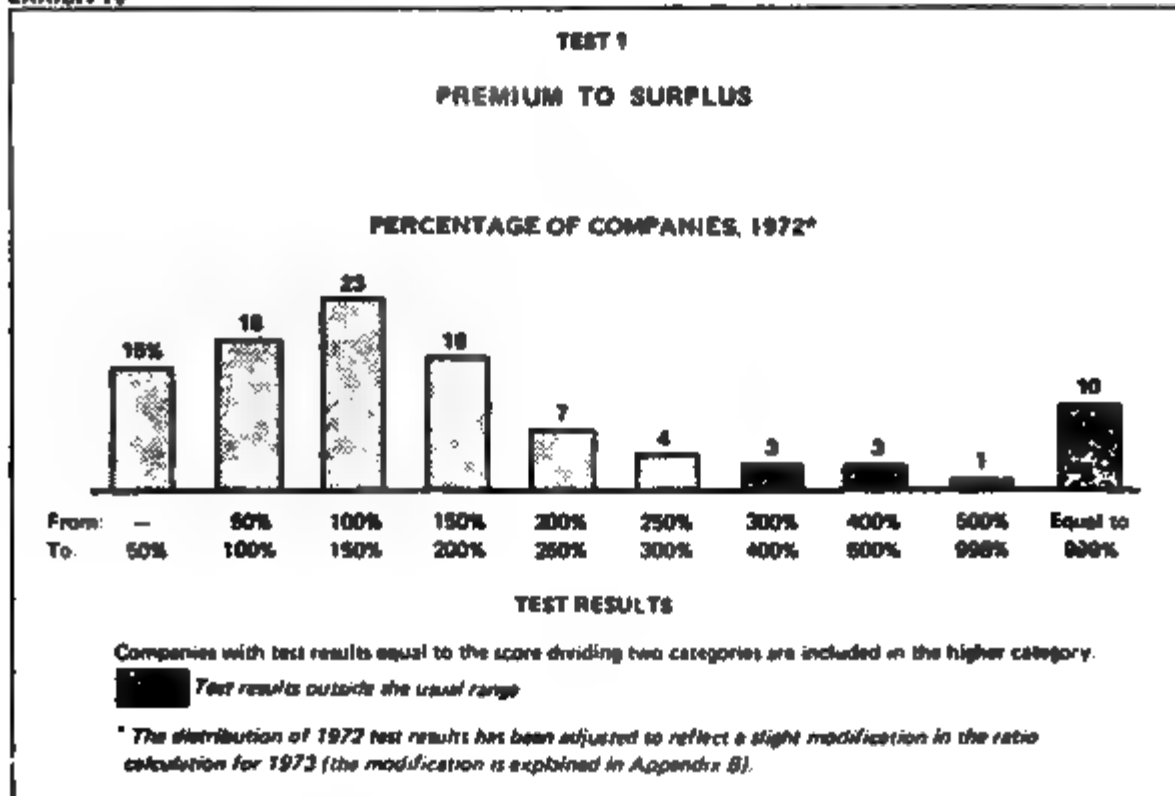


EXHIBIT IV



OVERALL TEST**TEST 1****PREMIUM TO SURPLUS**

A company's surplus provides a cushion for absorbing above-average losses. The premium to surplus ratio measures the adequacy of this cushion. The higher the ratio, the more risk the company bears in relation to the surplus available to absorb loss variations.

**DESCRIPTION OF
THE CALCULATION**

The premium to surplus ratio, as diagrammed in Exhibit III, is net premium written plus portfolio reinsurance ceded premium taken as a percentage of adjusted surplus. Surplus is adjusted for the estimated reserve deficiency or redundancy and for the excess of statutory over case basis reserves. The estimated reserve deficiency or redundancy is the average of the deficiency or redundancy of reserves as stated two years prior, one year prior, and in the current year; measured by the numerators of the three reserve tests. This average can be calculated quickly by multiplying current surplus by the average of the results for the three reserve tests (Tests 9, 10 and 11). The calculation of the premium to surplus ratio is laid out in the work sheets in Appendix A.

If adjusted surplus is zero or negative, the premium to surplus ratio is given as 999 percent.

**INTERPRETATION OF
TEST RESULTS**

The usual range for the premium to surplus test is up to 300 percent. As shown in Exhibit IV, 17 percent of all companies had test results at or above this bench mark in 1972. Of companies becoming insolvent in the past

five years, about 58 percent had a ratio of premium to surplus in excess of 300 percent three years prior to insolvency,* and 72 percent exceeded the bench mark in their final year.

A company's premium to surplus ratio can, of course, be improved through surplus aid reinsurance agreements. For companies near the 300 percent bench mark, therefore, the amount of surplus aid as measured by Test 3 should also be taken into consideration.

The severity of the potential problems that may result from high premium exposure in relation to surplus can be judged through further analysis directed at answering the following questions:

1. If the company is a member of a group of affiliated companies, what is the premium to surplus ratio of the group on a consolidated basis? The higher the risk to which other affiliated companies are exposed, the more cause for concern.
2. Is the company's insurance business profitable? Are profits stable? Are they increasing or decreasing? Tests 4 and 4A provide measures of profitability for five- and one-year periods. In general, companies with stable profits are able to sustain a higher ratio of premium to surplus without undue risk than companies with losses or unstable profits.
3. What is the distribution of premium between property and liability lines of business? Companies with a larger portion of premium from Schedule P lines should generally maintain a lower ratio of premium to surplus, due to the greater variability of losses and the difficulty of accurately estimating potential losses for these lines of business.
4. How adequate is the company's reinsurance protection against large losses, catastrophes, etc.?

In addition to providing protection against unusually high losses, surplus also provides a cushion against declines in the value of equity investments, such as common and preferred stocks. Although past experience indicates that the amount of investment in stocks would not in itself have been

* - Throughout this manual, references to the time of insolvency indicate the time when legal action was taken, not the time when financial impairment first occurred.

effective in distinguishing troubled from sound companies (see Appendix B), potential declines in the value of investments should be considered for any company shown to be in a risky position because of high premium exposure in relation to surplus. For such companies, further analysis should also be directed at answering the following questions:

1. How much of the company's assets are invested in stocks, real estate, and other equities? Are these investments properly valued? What percentage are they of surplus?
2. How variable are the values of these equity investments? Consideration should be given to each type of equity separately; for common stocks, riskiness varies significantly by industry and company.
3. If equity values declined at the same time that policy losses rose, how likely is it that the company would become, perhaps temporarily, insolvent?

TEST 2
CHANGE IN WRITINGS

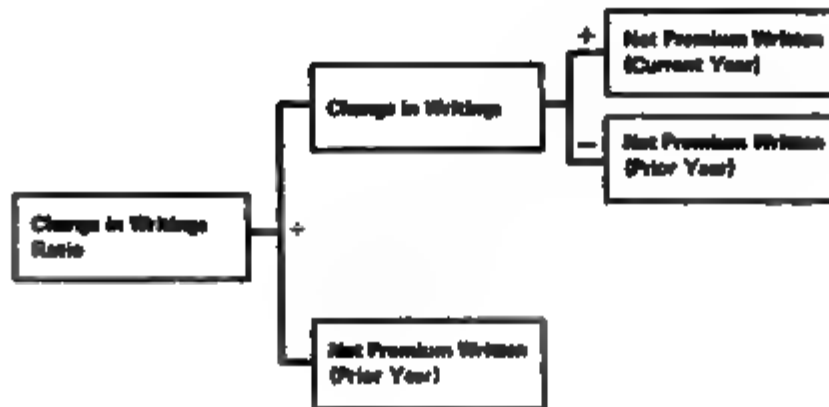
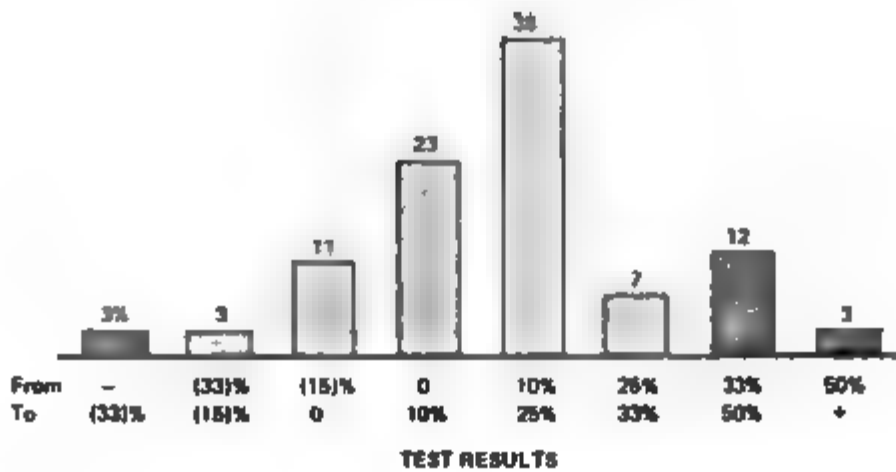


EXHIBIT VI

TEST 2
CHANGE IN WRITINGS
PERCENTAGE OF COMPANIES, 1972*



Companies with test results equal to the score dividing two categories are included in the higher category

* Based on a sample of 200 companies

OVERALL TEST**TEST 2****CHANGE IN WRITINGS**

Major increases or decreases in net premiums written indicate a lack of stability in the company's operations. A major increase in premium may signal abrupt entry into new lines of business or sales territories. In addition, such an increase in writings may be a sign that the company is increasing cash inflow in order to meet loss payments.

**DESCRIPTION OF
THE CALCULATION**

The change in writings ratio, as diagramed in Exhibit V, is the increase or decrease in net premiums written taken as a percentage of net premiums written in the prior year. If the net premium written is zero or negative in both the current and the prior year, the change in writings ratio is given as zero. If the net premium written is positive in the current year but zero or negative in the prior year, the change in writings ratio is given as 999 percent.

**INTERPRETATION
OF TEST RESULTS**

The usual range for the change in writings test is from an increase of 33 percent to a decrease of 33 percent. As shown in Exhibit VI, 18 percent of all companies fell outside of this range in 1972. Of companies becoming insolvent in the past five years, 43 percent had test results outside these bench marks in the third year prior to insolvency (all of which were beyond the upper growth bench mark), and 45 percent fell outside the bench marks in their final year (30 percent above and 15 percent below).

Familiarity with the company's operations and history is useful in judging the importance of test results falling beyond the bench marks. Such results frequently indicate a lack of stability in the company's operations and management. Other evidence of such instability may include dramatic shifts in product mix, marketing areas, underwriting policy, and similar factors.

Where an unstable situation is apparent, further analysis or examination should be directed at answering the following questions:

1. Are the company's assets properly valued and sufficiently liquid to meet possible cash demands? Consider the results on the ratio of liabilities to liquid assets (Test 7) and make a careful review of Schedule D.
2. Are the company's reserves adequate? Consider the results of the reserve tests (Tests 9, 10 and 11) and review Schedule P in detail.

It is important to determine whether a dramatic increase in writings indicates that the company is increasing cash flow in order to pay current claims. This may be the case if the company's recent reserves were inadequate (see the one- and two-year reserve development tests, Tests 9 and 10). If increased writings is accompanied by a shift to the liability lines of business, the problem is more serious. Increasing writings, particularly in the liability lines, to pay current claims provides a very short-lived solution to underlying problems and quickly increases the risk of insolvency. Immediate regulatory action may be required to deal with such a company.

On the other hand, if large increases in writings are accompanied by a reasonably low premium to surplus ratio (Text 1), adequate reserving (Tests 9, 10 and 11), profitable operations (Tests 4 and 4A) and a relatively stable product mix, they generally do not indicate difficulties that would threaten the company's solvency.

OVERALL TEST**TEST 3****SURPLUS AID TO SURPLUS**

The use of surplus aid reinsurance treaties may be taken as an indication that company management believes surplus to be inadequate. In addition, the continued solvency of companies with a large portion of surplus deriving from surplus aid may depend upon the continuing cooperation of the reinsurer.

**DESCRIPTION OF
THE CALCULATION**

Surplus aid consists of commissions on ceded reinsurance unearned premium. Since this amount cannot be determined exactly from the annual statement, it must be estimated. As shown in the diagram in Exhibit VII, this estimate is made by multiplying the ratio between ceding commissions and ceded premium for all reinsurance ceded by the amount of unearned premium on reinsurance ceded to nonaffiliated companies. This estimated surplus aid is taken as a percentage of stated surplus to obtain the test result. Unearned premium on reinsurance ceded to affiliated companies is excluded from the calculation to avoid prejudicing the test against members of groups or fleets with pooling arrangements. The surplus aid to surplus calculation is illustrated in the work sheet for Test 3 in Appendix A.

**INTERPRETATION
OF TEST RESULTS**

The usual range for the ratio of surplus aid to surplus is less than 25 percent. As shown in Exhibit VIII, about 5 percent of all companies scored above 25 percent on the surplus aid test in 1972. Of companies becoming insolvent in the past 5 years, 24 percent exceeded the surplus aid bench mark in the third year before insolvency, and 33 percent exceeded the bench mark in their final year.

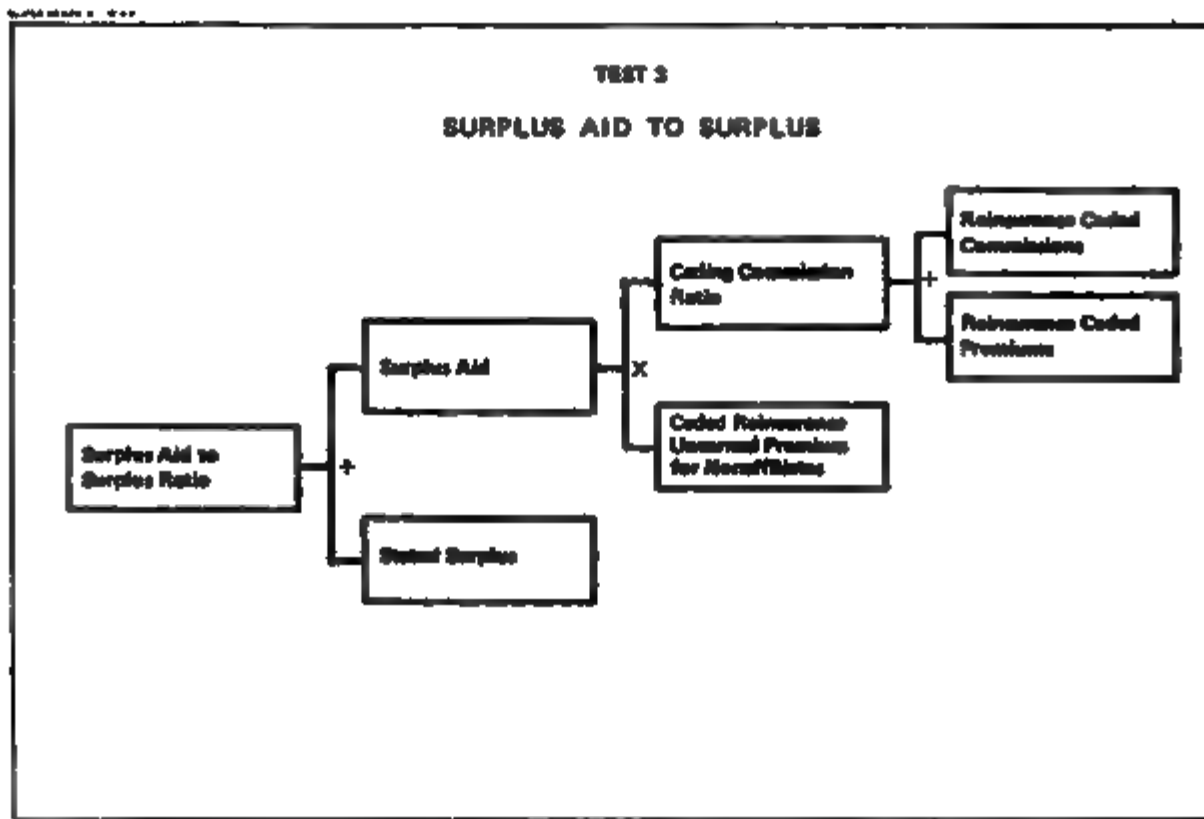
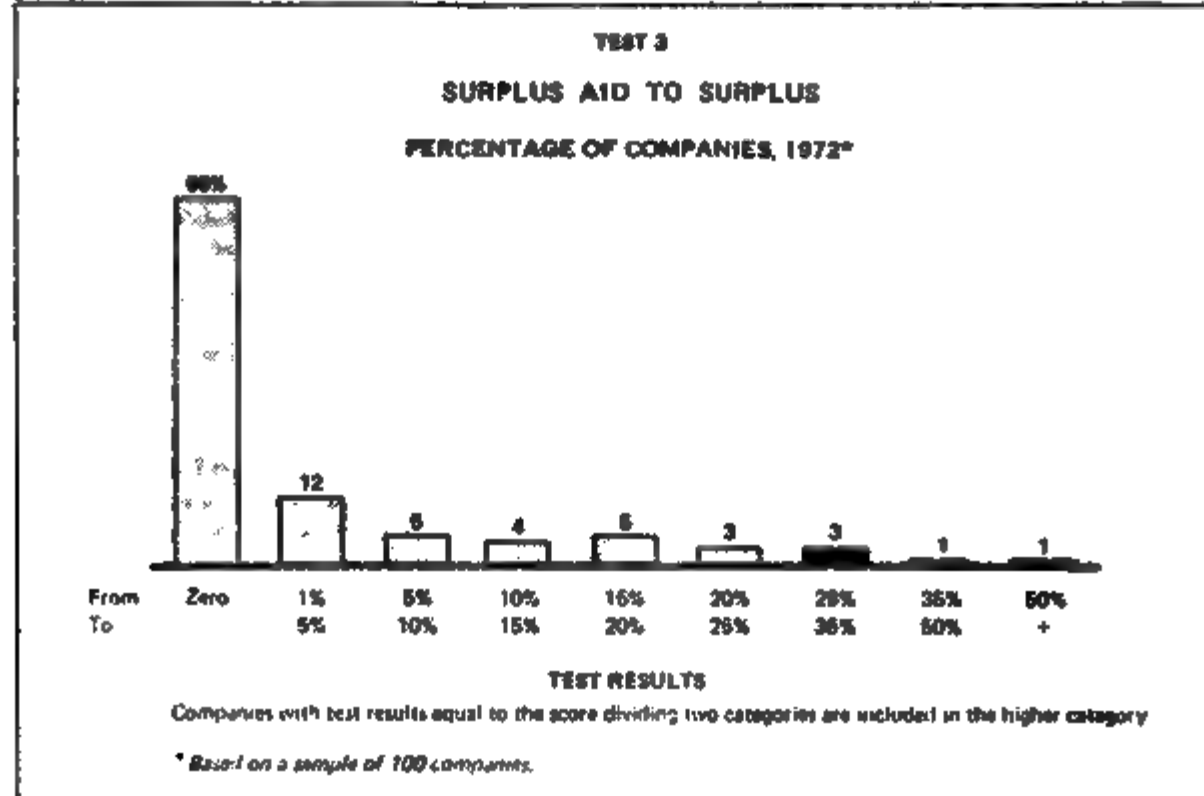


EXHIBIT VIII



The surplus aid test is of primary importance for two reasons:

1. The existence of significant amounts of surplus aid may be taken as a strong indication that surplus is inadequate.
2. Surplus aid may improve results on other tests enough to conceal important areas of concern.

For these reasons, all companies with ratios higher than 25 percent should be given careful scrutiny, regardless of their scores on the other tests. The following test results should be recalculated with surplus adjusted to remove surplus aid:

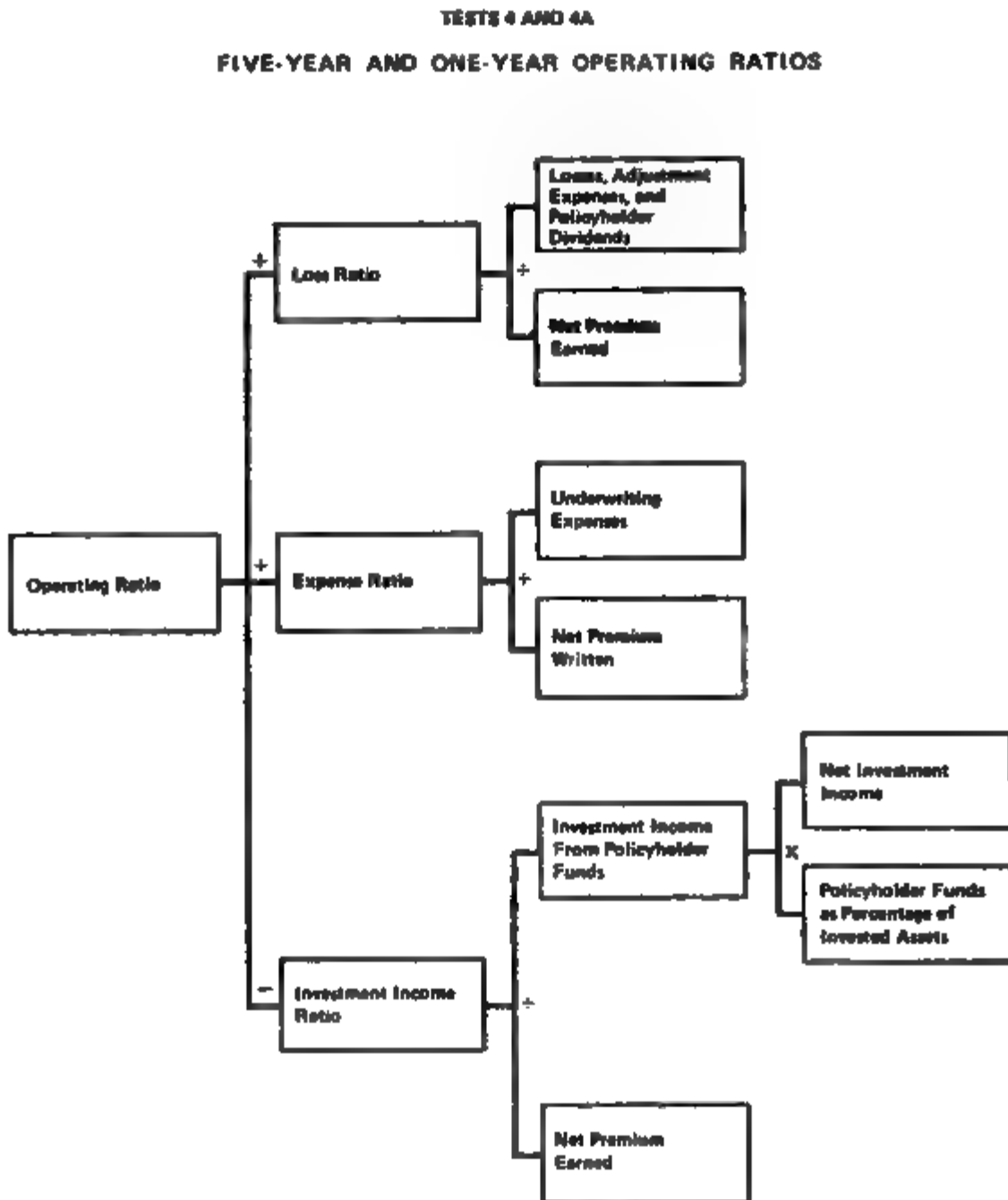
- § Premium to surplus (Test 1)
- § Change in surplus (Test 6)
- § Agent balances to surplus (Test 8)
- § One-year reserve development to surplus (Test 9)
- § Two-year reserve development to surplus (Test 10)
- § Estimated current reserve deficiency to surplus (Test 11).

Of course, these adjustments can be made without recalculating the numerator: simply divide the result for each test by the difference between one and the surplus aid test result expressed as a decimal.

If, as a result of this analysis, a company fails several of the above tests, it should be considered a priority company for examination. In any case, a thorough analysis should be made of the reinsurance treaties of all companies with a ratio of surplus aid to surplus of more than 25 percent. This analysis should determine the legitimacy of the company's reinsurance treaties and the potential impact on the company's solvency of a cancellation of these treaties.

The surplus aid test may also provide an approximate check on the accuracy with which the company has completed the reinsurance interrogatory in the association blank.

EXHIBIT IX



PROFITABILITY TEST

TESTS 4 AND 4A

FIVE-YEAR AND ONE-YEAR OPERATING RATIOS

The operating ratio is a comprehensive measure of the profitability of a company's insurance business. Over the long run, the profitability of the business is a principal determinant of the company's financial solidity and solvency.

**DESCRIPTION OF
THE CALCULATION**

Although the operating ratio is one of the more difficult ratios to calculate, the calculation is based on a simple concept. There are three key elements in operating profitability: losses, expenses, and the investment income from funds supplied by insurance operations. Operating profits consist of the difference between premium and the net result of these three factors. Therefore, as diagramed in Exhibit IX, the operating ratio is the net result of three component ratios:

- § Loss ratio
- § Expense ratio
- § Investment income ratio.

The loss ratio is the total of losses, loss adjustment expenses, and policyholder dividends taken as a percentage of net premium earned. The expense ratio is equal to underwriting expenses (net of other income) divided by net premium written. The sum of these two ratios is the combined ratio. From this combined ratio is subtracted the investment income ratio: net investment income earned on funds contributed by policyholders, taken as a percentage of net premium earned.

Investment income is earned on the total invested assets. One portion of these assets has been provided by policyholders (as indicated by liabilities such as reserves for losses and unearned premium). The other portion

has been provided by stockholders and the retention of profits (as indicated by surplus). Only the income earned on policyholders' funds is counted toward the profitability of the insurance business. If the total investment income were included, the resulting ratio would not measure the profitability of the insurance business per se, and the results obtained for companies with little premium in relation to investment income would be meaningless.

To determine what portion of investment income is earned on policyholder funds, investment income is multiplied by the ratio between policyholder funds and invested assets. Policyholder funds are calculated as the difference between invested assets and adjusted surplus. For this test, stated surplus is adjusted in three ways. First, the excess of statutory over case basis reserves is added to surplus. Second, surplus is decreased or increased by the estimated reserve deficiency or redundancy, which is the average of the numerators of the three reserve tests. Third, surplus is increased by the amount of deferred acquisition expenses. This amount is calculated by multiplying the unearned premium reserve by the ratio between acquisition expenses and net premium written. Acquisition expenses include commissions, taxes, licenses and fees, and half of other underwriting expenses.

The only difference between the five- and one-year operating ratios is that for the five-year ratio, the total amounts for the period are used in calculating the loss and expense ratios. The calculation has been simplified by using the current year investment income ratio in place of a five-year calculation. Because of the general stability of investment income, the results obtained in this manner normally do not differ materially from the results obtained through the more lengthy calculation.

If the net premium written or earned in the current year is zero or negative, the one-year operating ratio is not calculated. The five-year ratio is not calculated if the total net premium written or earned for the five-year period or for the current year is zero or negative.

The calculation of the five-year and one-year operating ratios is laid out in the work sheets in Appendix A.

APPROXIMATE CALCULATION OF FIVE-YEAR OPERATING RATIO FOR 1975

In order to calculate the five-year operating ratio, association blanks for the years 1969 through 1973 are needed. Due to the fact that a new

data processing company has begun calculating the test results this year, only the 1972 and 1973 blanks are centrally available. However, the 1972 five-year and one-year operating ratios are also available for most companies. With this information it has been possible to make a reasonable approximation of the five-year operating ratio for 1973.

The approximate five-year operating ratios included in the 1973 test results have been calculated as follows: First, an approximate four-year ratio for the period 1968 through 1971 was obtained from the five-year and one-year ratios calculated for 1972. This was done by adding to the 1972 five-year ratio one-quarter of the difference between that ratio and the 1972 one-year ratio. Second, the 1972 and 1973 association blanks were used to calculate a two-year operating ratio, as described above. Finally, the two-year ratio for 1972 and 1973 and the four-year ratio for 1968 through 1971 were averaged (with equal weights) to approximate the five-year ratio for 1969 through 1973.

If the operating ratios for 1972 are not available for a company, or if net premium earned during 1973 was zero or negative, no five-year operating ratio will be calculated for 1973.

The calculation of the one-year operating ratio for 1973 was not prevented by the lack of annual statements for earlier years and has been made as described in the work sheets for Test 4A in Appendix A. The work sheets for Test 4 show the manner in which the five-year ratio should be calculated if all the required annual statements are available.

INTERPRETATION OF TEST RESULTS

The usual range for the five-year and one-year operating ratios is less than 100 percent. In 1972, 17 percent of all companies had test scores above this bench mark on the five-year test (Exhibit X) and 12 percent on the one-year test (Exhibit XI). Of companies becoming insolvent during the past five years, 57 percent had five-year operating ratios in excess of the bench mark in the third year before insolvency, and 77 percent exceeded the bench mark in their final year.

If either the five-year or the one-year operating ratio is above the 100 percent bench mark, further analysis should be aimed at determining the trend in the company's profitability and the possible reasons for the high operating ratio. For priority companies, the trend in the operating ratio is

EXHIBIT X

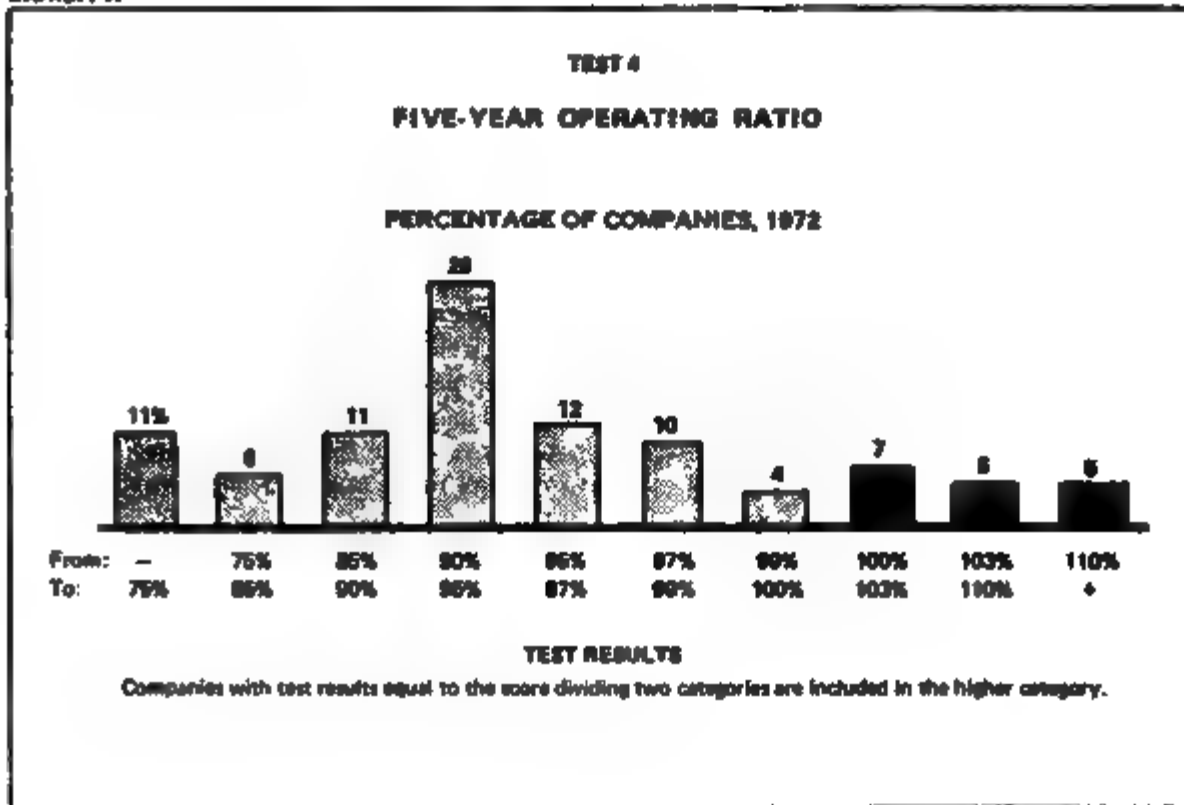
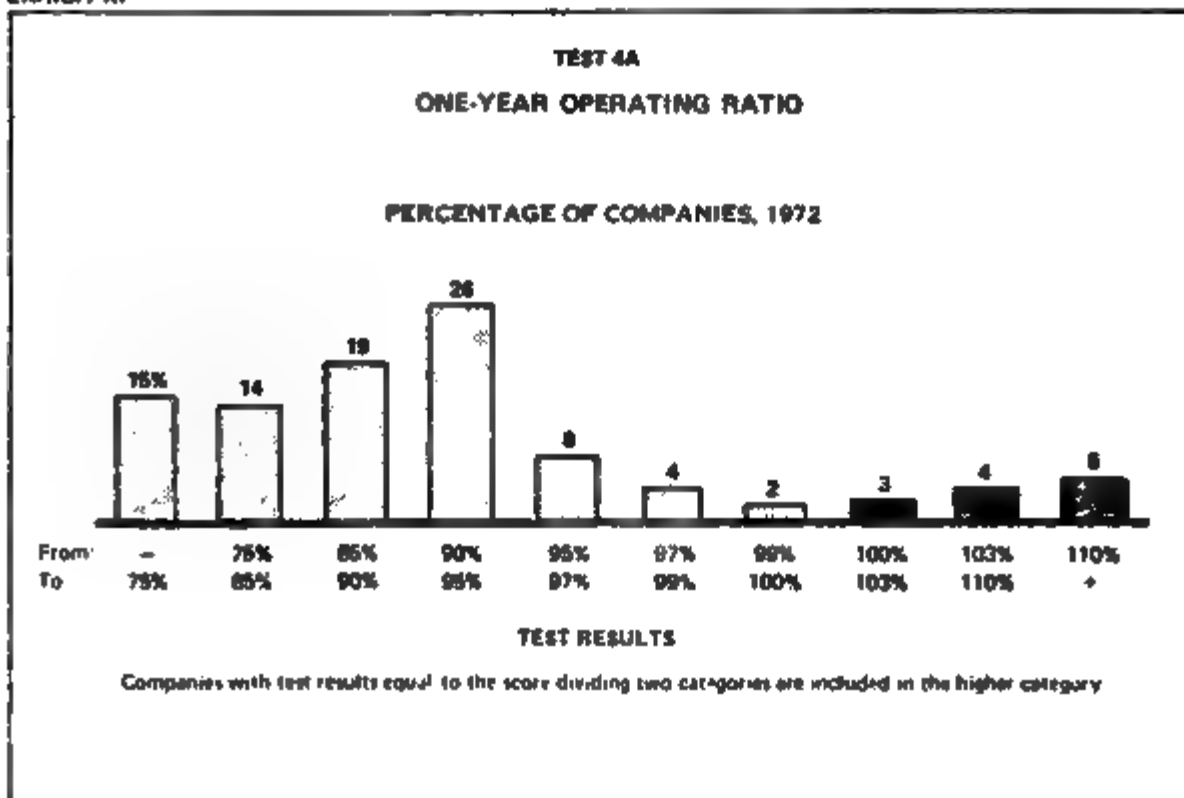


EXHIBIT XI



shown on the Priority Company Data Sheet. For other companies, the operating ratio should be calculated for each of the past three to five years. This work can be simplified by calculating the combined loss and expense ratio for each year and checking the trend in net investment income during the period.

Calculation of the combined ratio is also helpful in determining the reasons behind the company's poor performance - whether it is due to a high loss ratio or a high expense ratio. If the combined ratio is near 100 percent, poor performance may be the result of low investment income, which can be checked by the investment yield (Test 5).

EXHIBIT XII

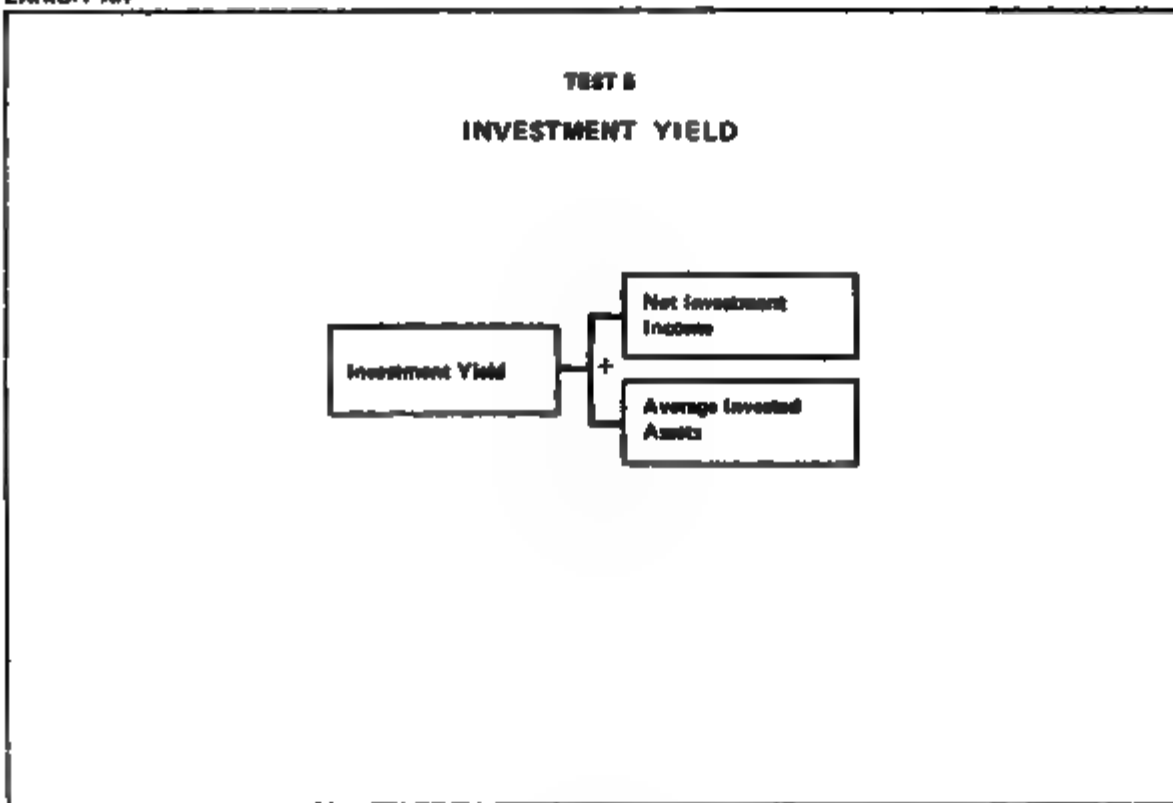
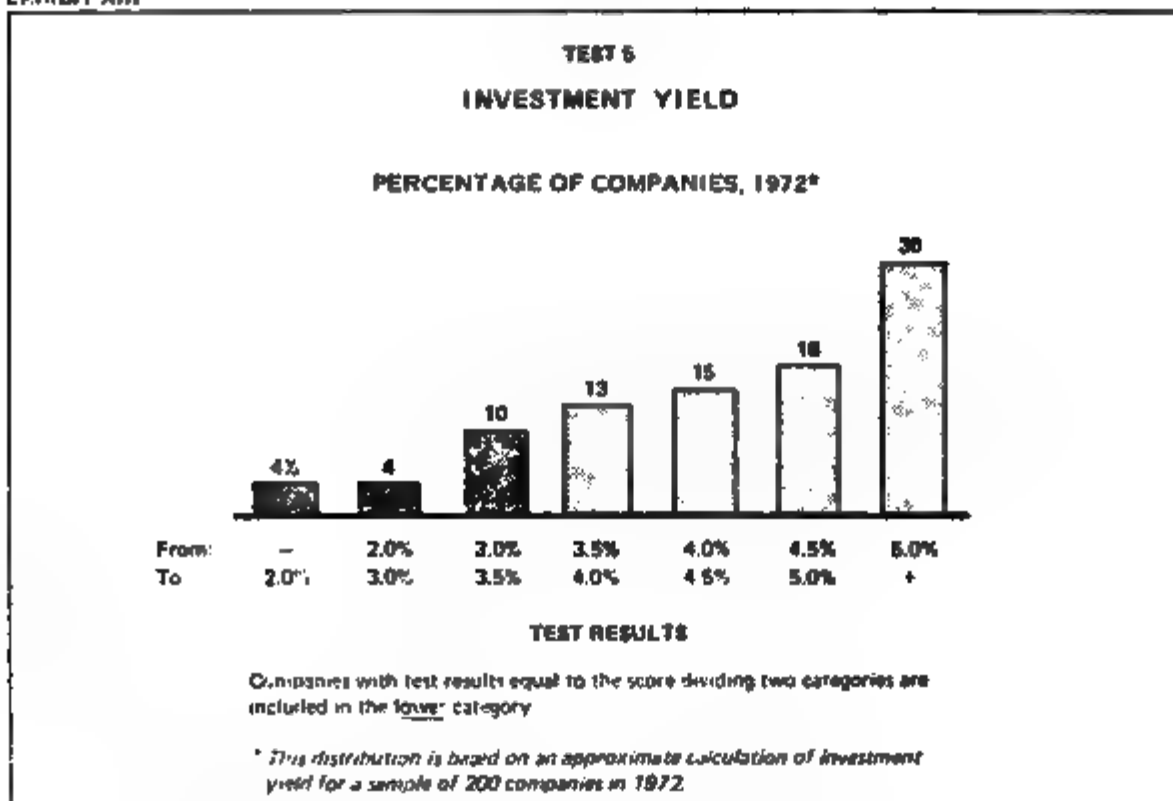


EXHIBIT XIII



PROFITABILITY TEST

TEST 5

INVESTMENT YIELD

In addition to measuring one important element in profitability, the investment yield test also provides an indication of the general quality of the company's investment portfolio.

DESCRIPTION OF THE CALCULATION

As shown in Exhibit XII, investment yield is net investment income as a percentage of the average invested assets during the year. Invested assets is the amount of cash and invested assets plus accrued investment income minus borrowed money. The average invested assets during the year is determined by taking half of the following sum: invested assets at the end of the prior year plus invested assets at the end of the current year minus net investment income during the year. This calculation is laid out in the work sheets in Appendix A.

INTERPRETATION OF TEST RESULTS

The usual range for investment yield is more than 3.5 percent. As shown in Exhibit XIII, 19 percent of all companies had investment yields below this bench mark in 1972. Of companies becoming insolvent during the past five years, about 62 percent had investment yields below 3.5 percent in the third year before insolvency, and 75 percent fell short of the bench mark in their final year.

Analysis of the reasons for a low investment yield may uncover significant problems. This analysis should include a determination of the types of investments (from page 2 and Schedule D) and of the yield on each type of investment (using page 5, Part 1). Low yields may be caused by:

1. Speculative investments intended to produce large capital gains over the long run, but providing little income in the interim. If this is the case, analysis should focus on the proper valuation of these investments and a determination of their stability and liquidity.
2. Large investments in affiliated companies or enterprises under the control of company managers or owners. If this is the case, analysis should focus on the propriety of these investments and their value and liquidity.
3. Large investments in home office facilities. If this is the case, analysis should focus on the ability of the company to afford its facilities while maintaining liquidity and on the appropriateness of the amount of rent charged to underwriting expenses and credited to investment income.

PROFITABILITY TEST

TEST 6

CHANGE IN SURPLUS

The change in surplus is, in a sense, the ultimate measure of the improvement or deterioration in the company's financial condition during the year.

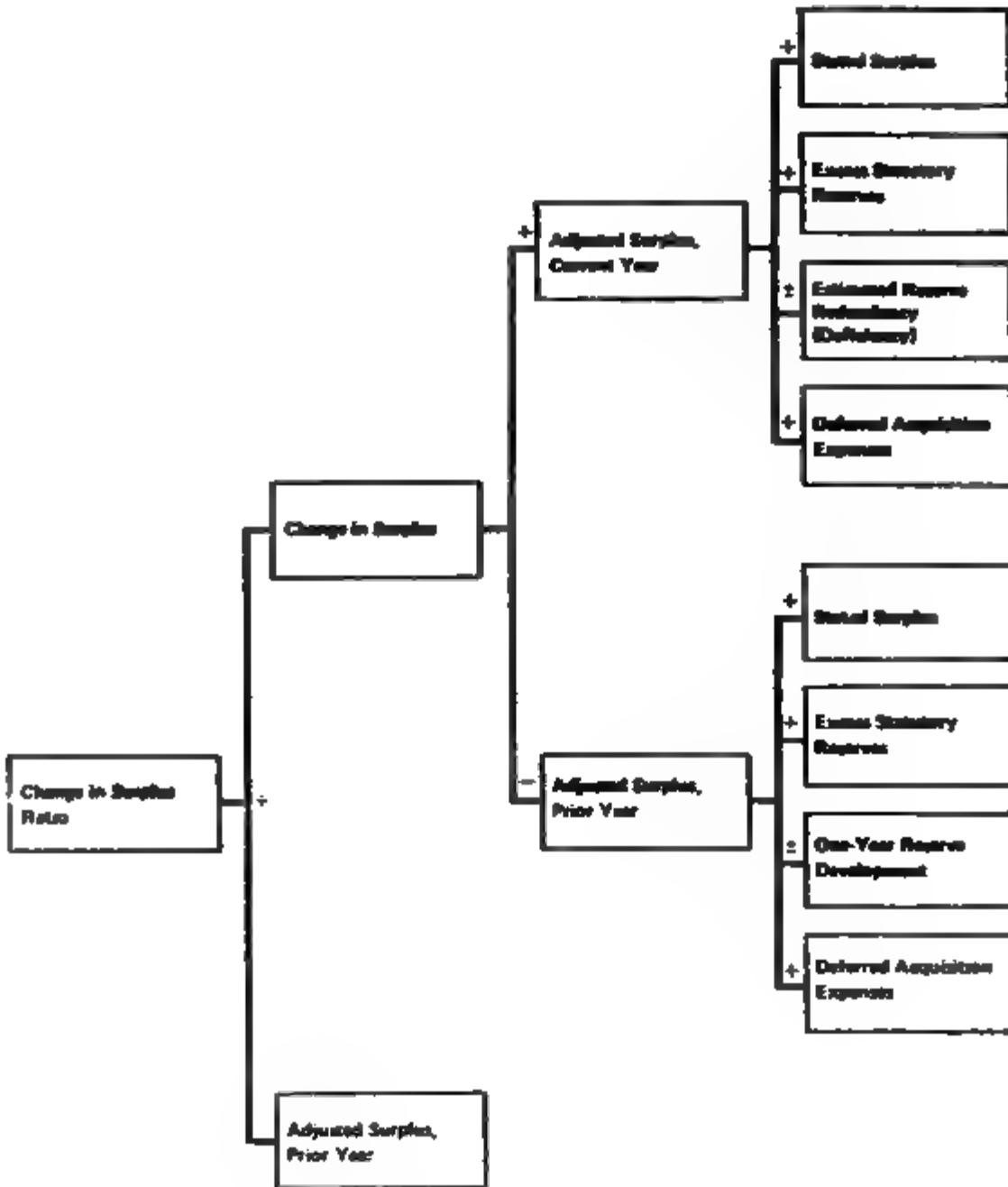
**DESCRIPTION OF
THE CALCULATION**

The calculation of the change in surplus test is diagrammed in Exhibit XIV and laid out in detail in the work sheets in Appendix A.

The change in surplus is the difference between surplus at the end of the current year and surplus at the end of the prior year, taken as a percentage of surplus at the end of the prior year. For this test, stated surplus for each year is adjusted in three ways. First, the excess of statutory over case basis reserves is added back to stated surplus. Second, surplus is adjusted for the deficiency or redundancy of loss reserves. The prior year surplus is decreased by any reserve deficiency revealed by the one-year reserve development (Test 9) or increased by any redundancy. The current year surplus is decreased or increased by the deficiency or redundancy of current reserves, as estimated by averaging the numerators of the three reserve tests (Tests 9, 10 and 11). Finally, surplus is increased by the deferred acquisition expenses. This amount is calculated by multiplying the unearned premium reserve by the ratio between acquisition expenses and net premium written. Acquisition expenses include commissions; taxes, licenses and fees, and half of all other underwriting expenses.

The adjustment for deferred acquisition expenses makes the change in surplus test somewhat more complex. However, it significantly improves the effectiveness of the test for distinguishing troubled from sound companies.

TEST 6
CHANGE IN SURPLUS

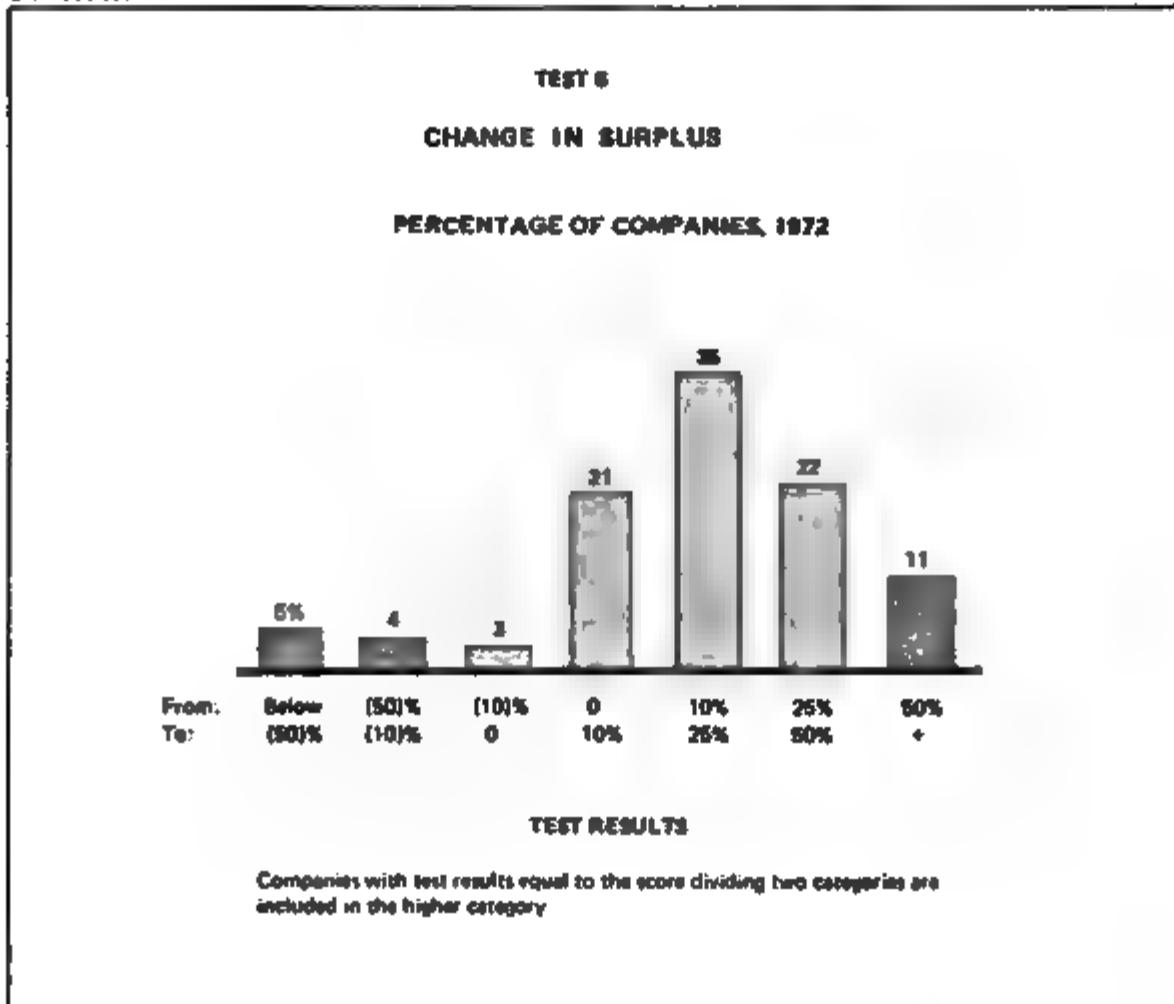


If the current year adjusted surplus is zero or negative, the test result is given as minus 99 percent. If the current year adjusted surplus is positive, but the prior year adjusted surplus is negative, the test result is given as 999 percent.

INTERPRETATION OF TEST RESULTS

The usual range for the change in surplus test is from minus 10 percent to plus 50 percent. In 1972, 20 percent of all companies had test results outside these bench marks (Exhibit XV). Of companies becoming insolvent during the past five years, 59 percent exceeded these bench marks three years before insolvency (with 16 percent above and 43 percent below the bench marks), and 85 percent did so in the final year (with 23 percent above and 62 percent below).

EXHIBIT XV



The reason for the minus 10 percent bench mark is clear. Any significant decrease in surplus is a cause for concern. The plus 50 percent bench mark has been included because a number of insolvent companies had dramatic increases in surplus prior to insolvency, whereas relatively few sound companies have more than 50 percent increases in surplus in one year. Major increases in surplus may be taken as an indication of instability and may sometimes be related to changes in ownership.

If the change in surplus ratio falls below the minus 10 percent bench mark, further analysis should be directed at determining the reasons for the change and the likelihood that these factors will be repeated in future years. This analysis should include comparing the adjustments to surplus in the two years and identifying the major factors affecting stated (unadjusted) surplus, including:

- ¶ Net gain or loss (also check operating ratio - Test 4A)
- ¶ Capital gains or losses
- ¶ Surplus paid in and dividends to stockholders
- ¶ Changes in nonadmitted assets
- ¶ Changes in surplus aid from reinsurance (check surplus aid - Test 3).

LIQUIDITY TEST

TEST 7

LIABILITIES TO LIQUID ASSETS

The ratio of liabilities to liquid assets is a measure of the company's ability to meet the financial demands that may be placed upon it. It also provides a rough indication of the possible implications for policyholders if liquidation becomes necessary.

**DESCRIPTION OF
THE CALCULATION**

As shown in Exhibit XVI, the ratio represents adjusted liabilities taken as a percentage of liquid assets. Adjusted liabilities are equal to stated liabilities minus the excess of statutory over case basis reserves and plus or minus the current reserve deficiency or redundancy, which is estimated as the average of the numerators of the three reserve tests (Tests 9, 10 and 11).

Liquid assets are calculated as total cash and invested assets plus accrued investment income minus any investments in affiliated companies and minus any excess of investments in real estate over 5 percent of adjusted liabilities as calculated above. Note that bonds are included in this ratio at their annual statement value, which is not necessarily equal to their "liquidation" or market value.

The calculation of this ratio is laid out in detail in the work sheets in Appendix A.

**INTERPRETATION
OF TEST RESULTS**

The usual range for the liabilities to liquid assets ratio is below 100 percent. As shown in Exhibit XVII, 13 percent of all companies had ratios above 100 percent in 1972. Of companies becoming insolvent in the past five years, 67 percent had test results beyond the bench mark in the third year before insolvency, while 84 percent exceeded the bench mark in their final year.

EXHIBIT XVI

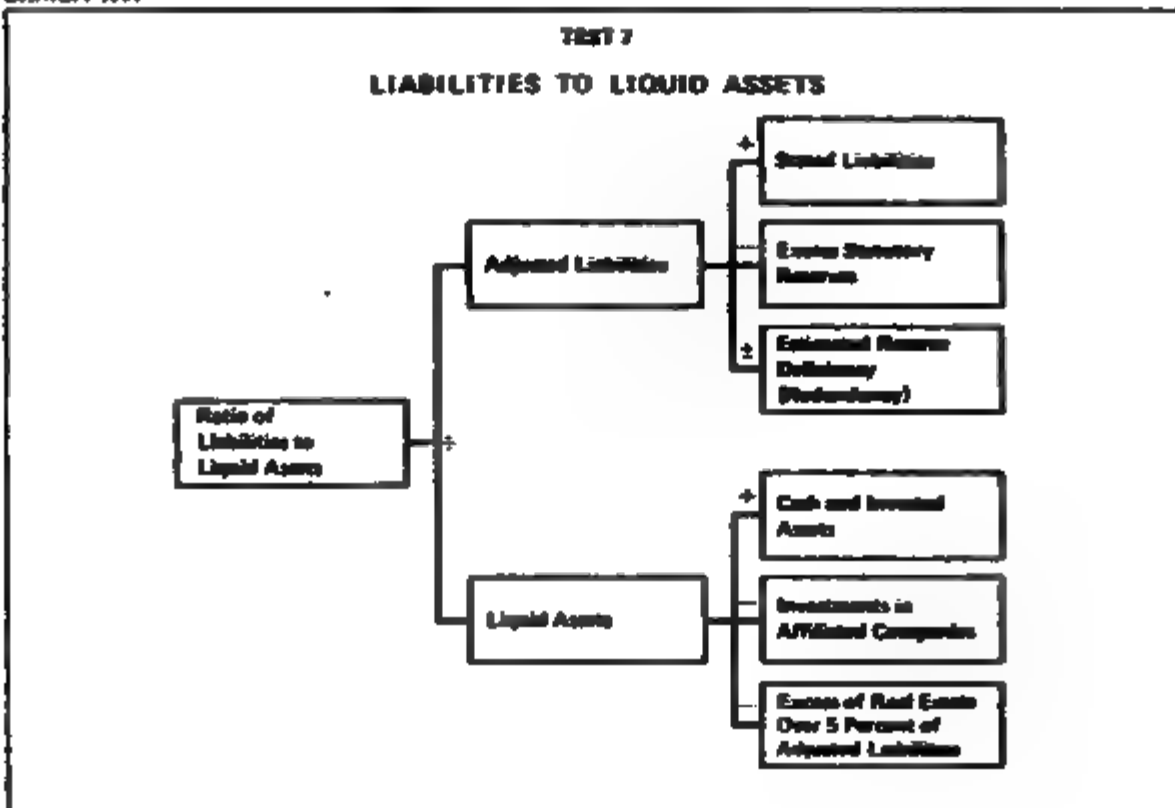
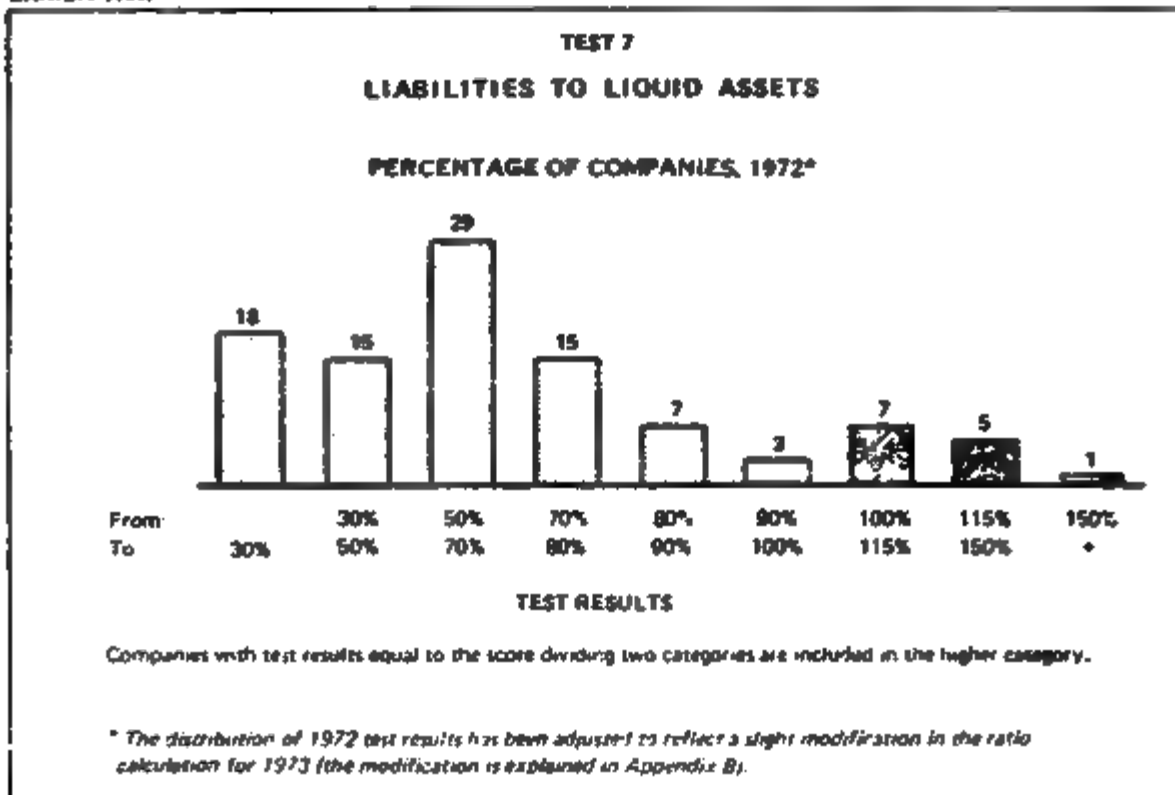


EXHIBIT XVII



Analysis of insolvent companies shows that many companies heading for insolvency had increasing ratios of liabilities to liquid assets in their final years. Thus, in interpreting test results, it is important to consider the trend in this ratio, as well as the ratio itself.

Note that companies maintaining large deposits with ceding reinsurers tend to have unduly high test results. These deposits are excluded from liquid assets, but the offsetting liability is included in liabilities.

In general, further analysis for companies with high ratios of liabilities to liquid assets should focus on the adequacy of reserves and the proper valuation, mix and liquidity of assets, to determine whether the company is likely to be able to meet its obligations to policyholders.

EXHIBIT XVIII

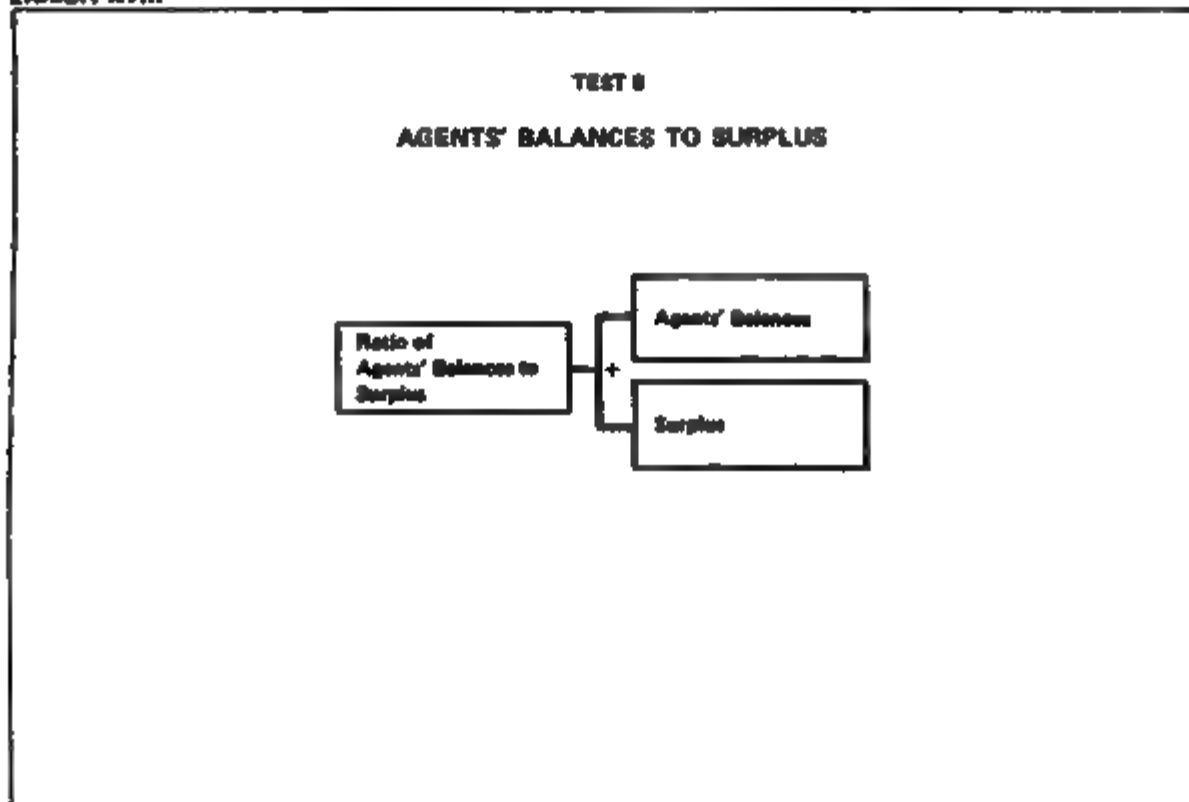
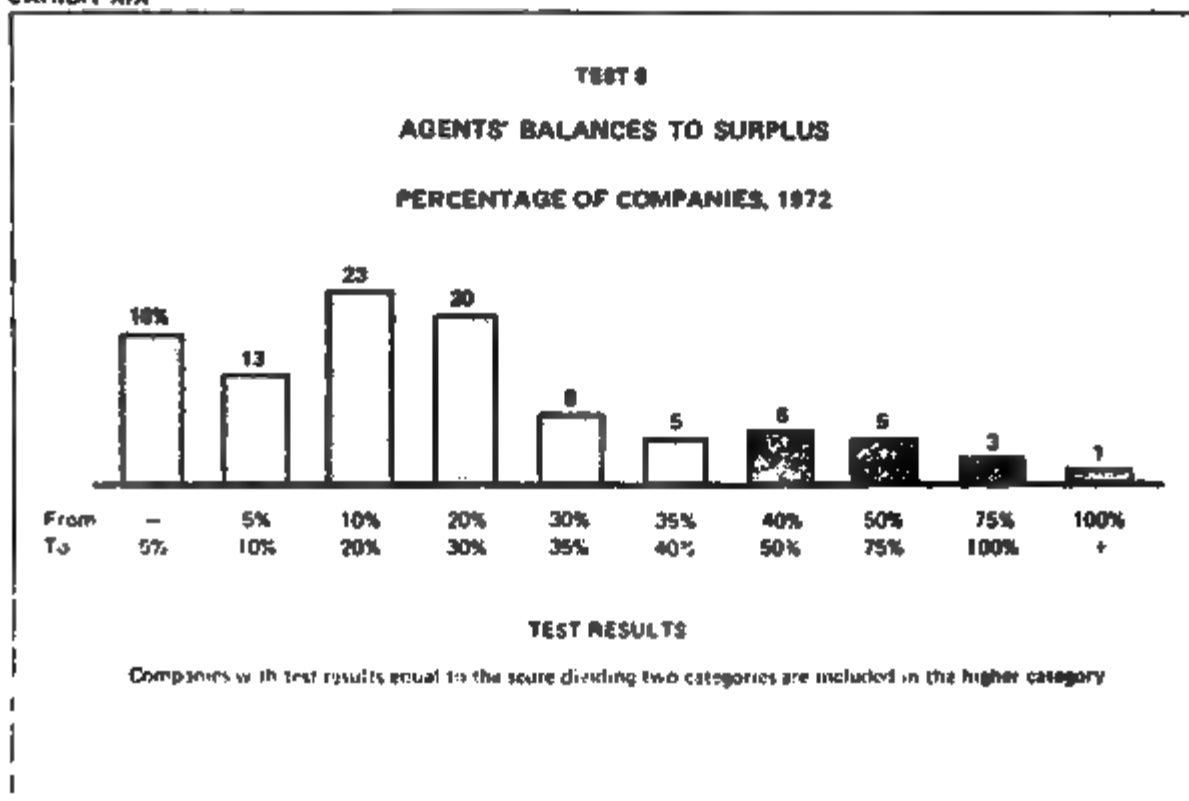


EXHIBIT XIX



LIQUIDITY TEST

TEST 8

AGENTS' BALANCES TO SURPLUS

The ratio of agents' balances to surplus measures the degree to which solvency depends upon an asset which frequently cannot be realized in the event of liquidation. In addition, the ratio is reasonably effective in distinguishing troubled from sound companies.

The ratio represents the amount of agents' balances taken as a percentage of stated surplus (Exhibit XVIII).

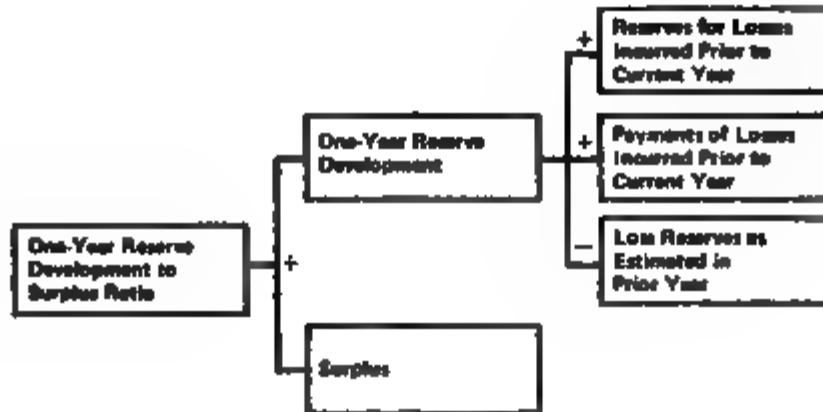
The usual range for the agents' balances to surplus ratio is less than 40 percent. As shown in Exhibit XIX, 15 percent of all companies had ratios above 40 percent in 1972. Of companies becoming insolvent during the past five years, 64 percent had ratios above this bench mark in the third year before insolvency, while 67 percent exceeded the bench mark in their final year.

The test result can, of course, be improved by surplus aid reinsurance.

If the amount of agents' balances is of concern, further analysis should determine whether agents' balances over 90 days old may have been included as an admitted asset. A quick check can be made by comparing agents' balances with one-quarter of the year's direct premium written and reinsurance assumed, net of commissions. This latter amount represents approximately 90 days of agents' balances.

EXHIBIT XX

TEST 9
ONE-YEAR RESERVE DEVELOPMENT TO SURPLUS



RESERVE TEST

TEST 9

ONE-YEAR RESERVE DEVELOPMENT TO SURPLUS

In addition to measuring the accuracy with which reserves were established one year ago, the ratio of one-year reserve development to surplus provides an indirect indication of management's opinion of the adequacy of surplus. Unless surplus is felt to be low, management frequently tends to overestimate reserves, for income tax and other reasons.

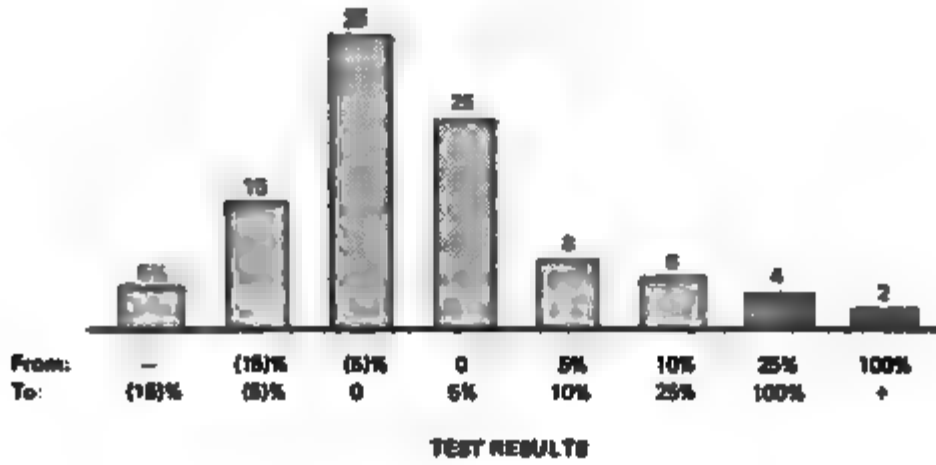
DESCRIPTION OF
THE CALCULATION

The most up-to-date estimate of the losses that were outstanding a year ago is the sum of the current reserves for those losses still outstanding plus the payments on those losses made during the past year. The difference between this current estimate and the reserves that were established at the end of the prior year is the one-year reserve development. If the current estimate is greater, the prior year's reserves were deficient, as judged by one year's hindsight. If the current estimate is less, the reserves were redundant. The ratio of one-year reserve development to surplus is this deficiency or redundancy taken as a percentage of surplus. A positive test result indicates a deficiency, while a negative test result indicates a redundancy. The calculation of this ratio is illustrated in Exhibit XX and laid out in detail in the work sheet for Test 9 in Appendix A.

For the property lines of business, the amount of salvage and subrogation applicable to prior years' losses received during the current year is subtracted from the change in losses for prior years. For liability lines, salvage and subrogation have already been netted out in the association blank. For liability lines, loss adjustment expenses are included in a manner similar to the treatment of losses; loss adjustment expenses are not included for property lines. It should also be noted that the test does not take into account voluntary reserves or the excess of statutory over case basis reserves.

EXHIBIT X39

TEST 9
ONE-YEAR RESERVE DEVELOPMENT TO SURPLUS
PERCENTAGE OF COMPANIES, 1972



Companies with test results equal to the score dividing two categories are included in the higher category.

For groups and fleets with pooling agreements, the one-year reserve deficiency for the group is calculated on a consolidated basis and allocated to the member companies according to each company's pool percentage. This allocated deficiency or redundancy is then taken as a percentage of surplus for each company.

INTERPRETATION OF TEST RESULTS

The usual range for the ratio of one-year reserve development to surplus is less than 25 percent. As shown in Exhibit XXI, 6 percent of all companies had a one-year reserve development of more than 25 percent of surplus in 1972. Of companies becoming insolvent during the past five years, 73 percent had one-year reserve development ratios in excess of the bench mark in the third year before insolvency, while 62 percent exceeded the bench mark in their final year.

The bench mark for this test has been set at 25 percent because very few insolvent companies had test results between the former bench mark of 10 percent and 25 percent (see Appendix B). However, any company with a significant positive score on this test should be given further analysis.

For companies whose reserves appear to be deficient, further analysis should focus on determining which lines of business caused the deficiency and whether the deficiency is the result of deliberate understatement of losses. The amount of deficiency for each line of business can be determined from Schedules O and P.

Two approaches are useful in efforts to determine whether reserve deficiencies result from deliberate understatement of liabilities. First, review results on the one- and two-year reserve development tests over the past several years. If reserves have been consistently deficient, or if the two-year test result is consistently worse than the one-year test result, the problem is more serious. Second, calculate the reserve development for longer periods of time for the liability lines of business, using Parts 3 and 4 of Schedule P. If the deficiencies increase with the time since the losses were incurred, the company may be deliberately underreserving, with deficiencies appearing only as losses are paid.

It is not possible to determine from the association blank itself whether reserve deficiencies result from payments in excess of the amounts reserved, increases in the reserves for losses still outstanding, or underestimation of incurred but not reported losses. Because it is also not possible to determine from the association blank whether loss payments and reserves have been assigned to the proper years, an on-site examination will generally be required to resolve any serious questions regarding the adequacy of reserves.

RESERVE TEST

TEST 10

TWO-YEAR RESERVE DEVELOPMENT TO SURPLUS

The two-year reserve development to surplus ratio is calculated in a manner similar to the calculation of the one-year reserve development test. The two-year reserve development is the sum of the current reserve for losses incurred more than two years prior plus payments on those losses during the past two years minus the reserves that had been established for those losses two years earlier. This calculation is illustrated in Exhibit XXII and laid out in detail in the work sheet for Test 10 in Appendix A.

EXHIBIT XXII

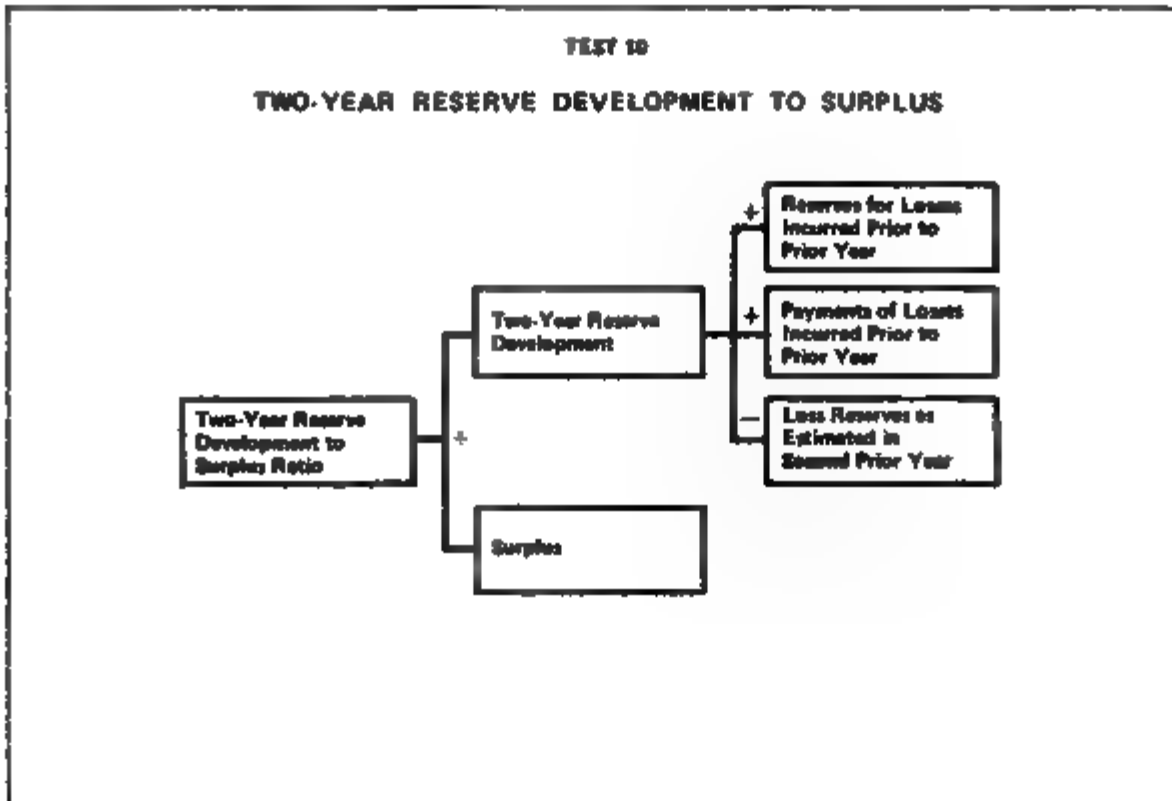
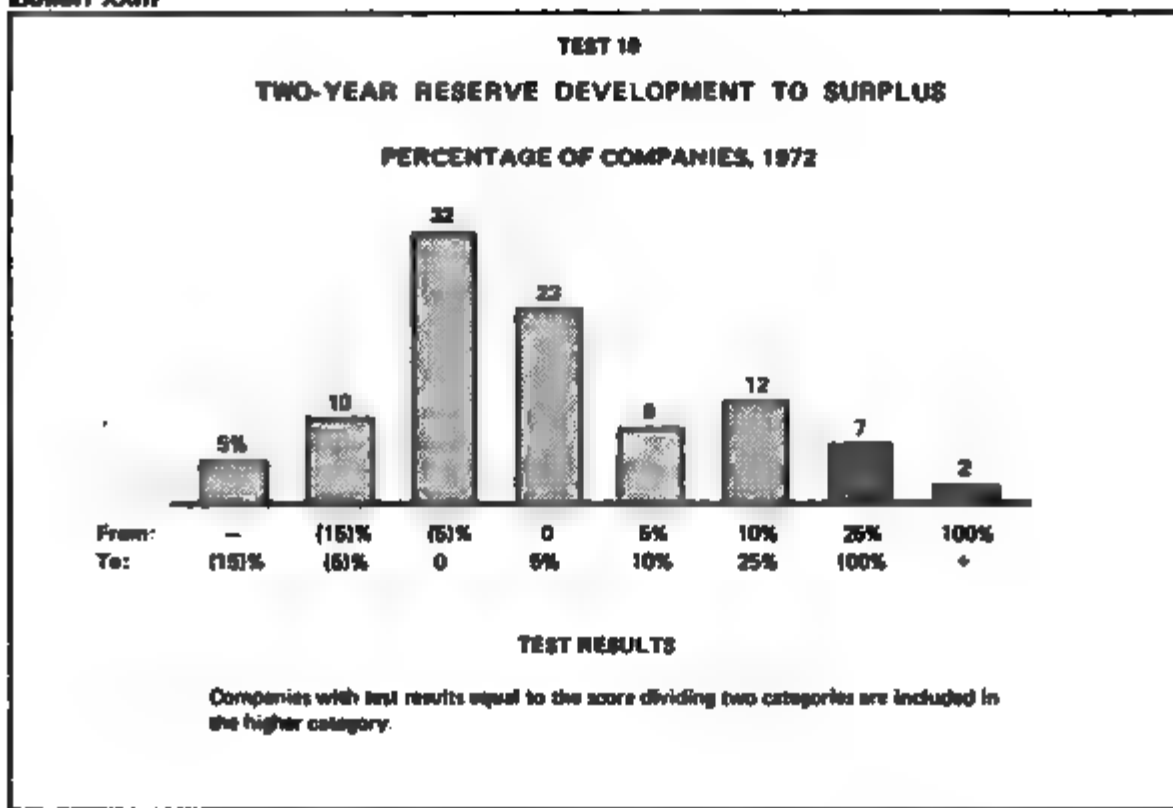


EXHIBIT XXIII



The usual range for the two-year test is also less than 25 percent. As shown in Exhibit XXIII, 9 percent of all companies had two-year reserve development to surplus ratios above 25 percent in 1972. Of companies becoming insolvent during the past five years, 73 percent had test results in excess of the bench mark in the third year before insolvency, while 60 percent exceeded the bench mark in their final year.

For suggestions on interpreting test results and further analysis, please refer to the comments on the one-year reserve development test.

RESERVE TEST

TEST 11**ESTIMATED CURRENT RESERVE DEFICIENCY TO SURPLUS**

This test provides an estimate of the adequacy of current reserves.

**DESCRIPTION OF
THE CALCULATION**

In this test, as shown in Exhibit XXIV, the estimated current reserve deficiency or redundancy is taken as a percentage of surplus. This estimated deficiency is the difference between the estimated reserves required by the company and the actual reserves maintained. The estimated reserves required is the current net premium earned multiplied by the average ratio between developed reserves and earned premium for the last two years. For each of these years the reserves as stated in that year are adjusted by the one- or two-year reserve development as calculated in Tests 9 and 10. This total is then divided by the net premium earned in the appropriate year to obtain the developed reserve to premium ratio. This calculation is laid out in detail in the work sheet for Test 11 in Appendix A.

**INTERPRETATION
OF TEST RESULTS**

The usual range for the ratio of estimated current reserve deficiency to surplus is less than 25 percent. As shown in Exhibit XXV (following), 8 percent of all companies had ratios in excess of the 25 percent bench mark in 1972. Of companies becoming insolvent in the past five years, 55 percent exceeded this bench mark in the third year prior to insolvency, and 58 percent did so in their final year.

Results on this test can be distorted by significant changes in premium volume. A major increase in premium earned can produce test results that indicate deficiencies greater than the actual deficiency, and vice versa. However, within the normal range of variations in premium from year to year, the distortion from changes in premium is not significant.

EXHIBIT XXIV

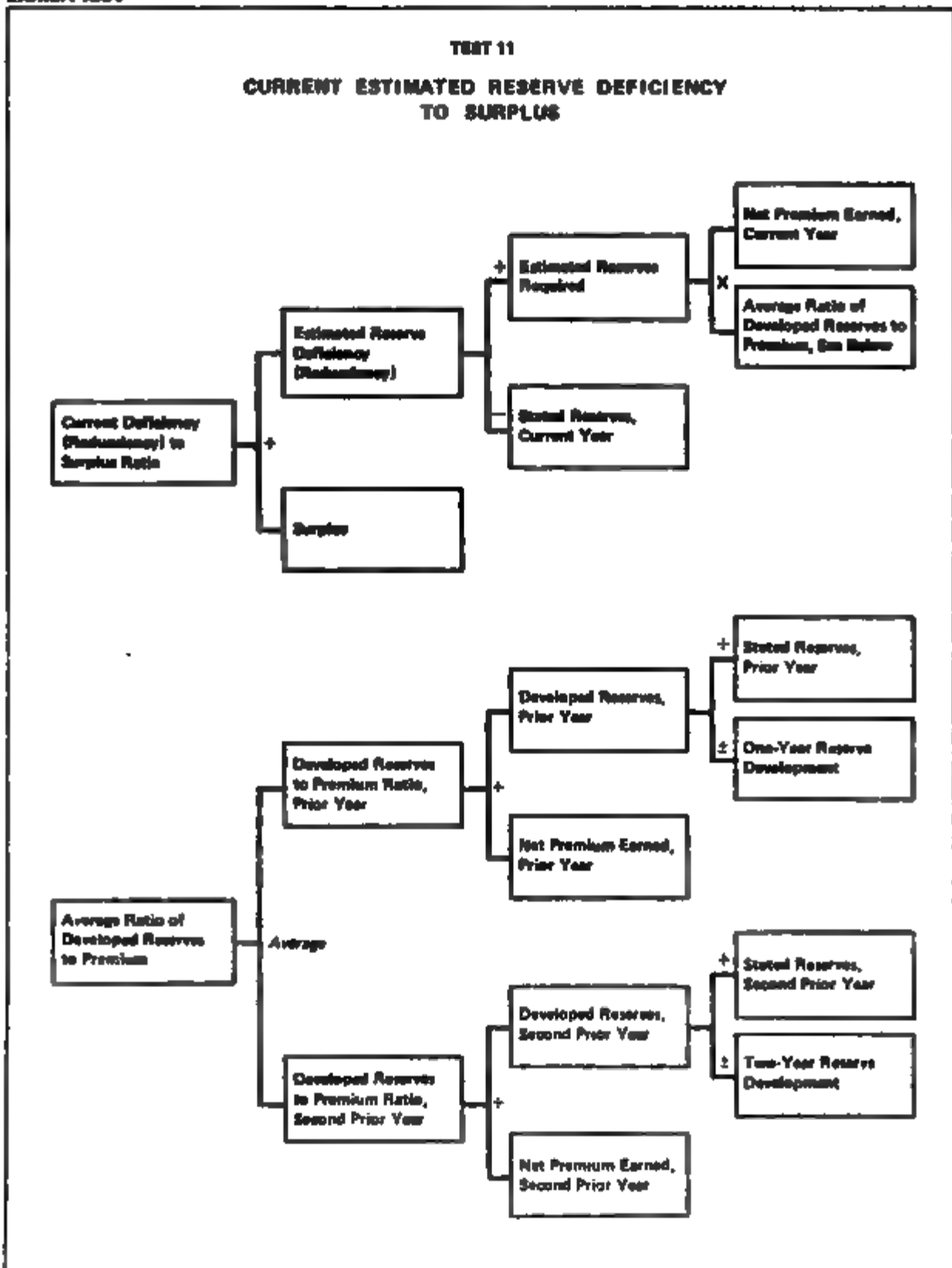
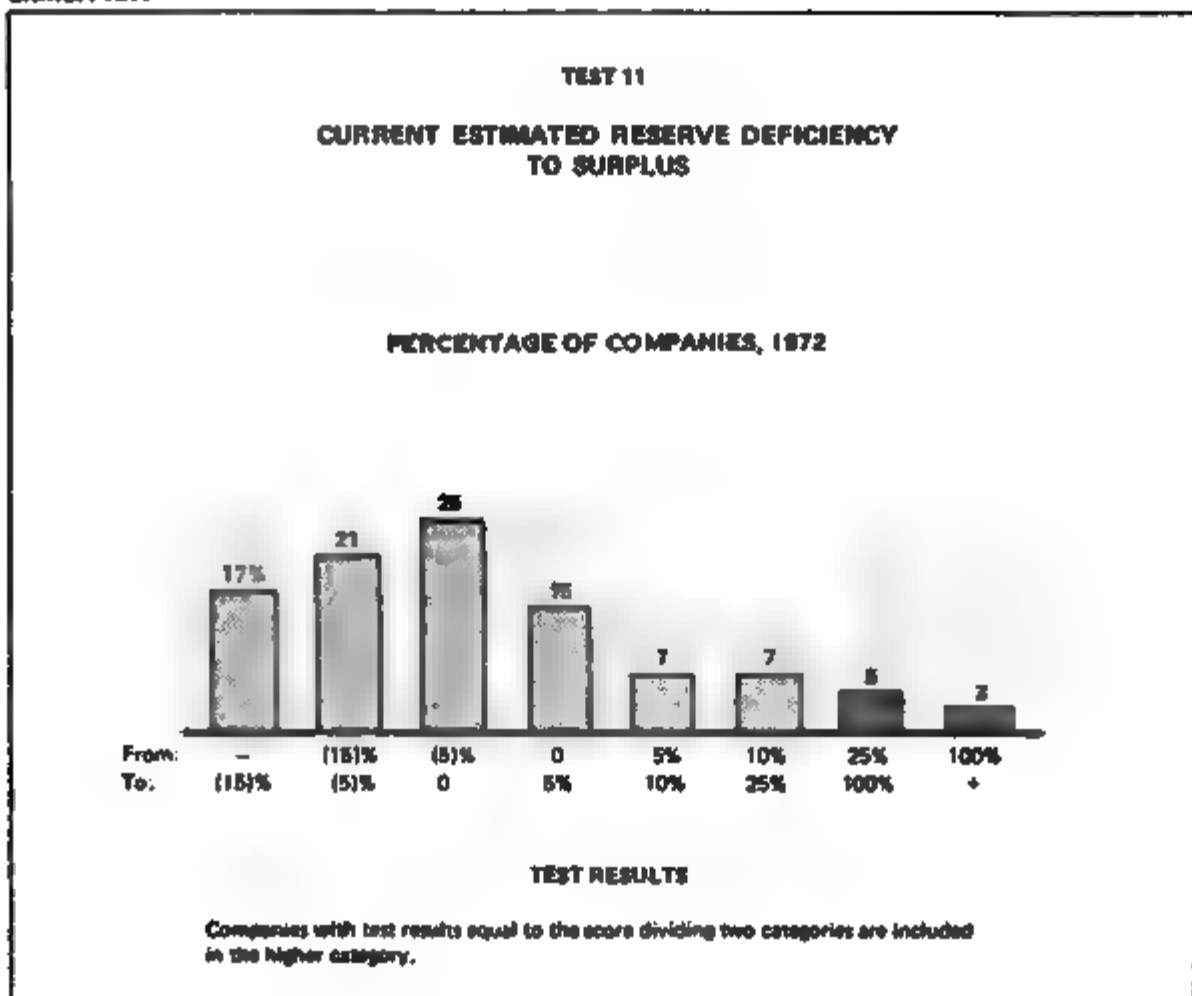


EXHIBIT XXV



Test results can also be affected by changes in product mix, especially if there is a change in the balance between property and liability lines of business. A significant shift in premium from property to liability lines will cause this test to underestimate reserve deficiencies. For companies that have had major shifts in product mix, the estimated current reserve deficiency or redundancy should be calculated separately for the major product groups, using the approach described above for each.

Within these limitations, the test provides a reasonable estimate of the adequacy of reserves and can be used to determine whether a company has corrected reserve deficiencies that may have existed in the past.

AUDIT RATIO WORK SHEETS

The following work sheets for the Early Warning System audit ratios can be copied as needed for manual calculation of test results. They are also intended to provide a precise illustration of how the audit ratios are calculated. References (by page, line, and column) are to the NAIC association blank. All references are to the current year's association blank unless otherwise indicated.

TEST 1 PREMIUM TO SURPLUS

 Company

 Year

Note: If adjusted surplus (Line 10) is zero or negative, the test result is 000 percent.

Premium

1. Page 7 Part 2C Column 4 Line 31 \$ _____
2. Schedule F Part 1B Section (a)
Total in Last Column \$ _____
3. Line 1 + Line 2 \$ _____

Adjusted Surplus

4. Page 3 Line 27 \$ _____
5. Page 3 Line 18 \$ _____
6. Test 9 Work Sheet Line 18 \$ _____
7. Test 10 Work Sheet Line 18 \$ _____
8. Test 11 Work Sheet Line 19 \$ _____
9. Average of Lines 6, 7, and 8* \$ _____
10. Line 4 + Line 5 - Line 9 \$ _____

Test Result

11. Line 3 ÷ Line 10 _____ %

* If work sheets for Tests 9, 10, and 11 are not being completed, this reserve adjustment can easily be obtained by multiplying current year surplus (Line 4 above) by the average of the results on Tests 9, 10, and 11, as provided in the current year's summary releases.

TEST 2 CHANGE IN WRITINGS

 Company

 Year

Note: If net premium written is zero or negative in both years (Lines 1 and 2), test result is zero. If net premium written is zero or negative in the prior year (Line 2) only, test result is 999 percent.

Change in Writings

- 1 Current Year Statement
Page 7 Part 2C Column 4 Line 31 \$ _____
- 2 Prior Year Statement
Page 7 Part 2C Column 4 Line 31 \$ _____
- 3 Line 1 — Line 2 \$ _____

Prior Year Writings

- 4 Prior Year Statement
Page 7 Part 2C Column 4 Line 31 \$ _____

Test Result

- 5 Line 3 ÷ Line 4 _____ %

TEST 3 SURPLUS AID TO SURPLUS

 Company

 Year

Surplus Aid

1 Page 10 Column 4 Line 2C \$ _____

2 Page 7 Part 2C Column 3 Line 31 \$ _____

3 Line 1 + Line 2 _____

4 Schedule F Part 1A Section (1)
Column 4 Total for Nonaffiliates \$ _____

5 Line 3 X Line 4 \$ _____

Surplus

6 Page 3 Line 27 \$ _____

Test Result

7 Line 5 + Line 6 _____ %

TEST 4 Work Sheet 1 FIVE-YEAR OPERATING RATIO

	Company

	Year

Note: No test result is calculated if any of the following figures is zero or negative: the current year's net premium earned (Line 8 below) or written (Line 16 on Work Sheet 4) or the five-year total of net premium earned (Line 22 on Work Sheet 2) or written (Line 27 on Work Sheet 3).

Loss Ratio

1 Work Sheet 2 Line 23 _____ %

Expense Ratio

2 Work Sheet 3 Line 26 _____ %

Investment Income Ratio

3. Page 4 Line 8		\$ _____	
4 Work Sheet 4 Line 24	\$ _____		
5 Page 2 Total for Lines 17 and 14	\$ _____		
6. Line 4 ÷ Line 5		_____	
7 Line 3 X Line 6		\$ _____	
8 Page 4 Line 1		\$ _____	
9 Line 7 ÷ Line 8			_____ %

Test Result

10 Line 1 + Line 2 - Line 9 _____ %

TEST 4 Work Sheet 2 FIVE-YEAR OPERATING RATIO

			Company

			Year
Losses, Adjustment Expenses, and Policyholder Dividends			
Current	1. Page 4 Line 2	\$ _____	
Year	2. Page 4 Line 3	\$ _____	
Statement	3. Page 4 Line 18A	\$ _____	
Prior	4. Page 4 Line 2	\$ _____	
Year	5. Page 4 Line 3	\$ _____	
Statement	6. Page 4 Line 18A	\$ _____	
Second	7. Page 4 Line 2	\$ _____	
Prior	8. Page 4 Line 3	\$ _____	
Year	9. Page 4 Line 18A	\$ _____	
Third	10. Page 4 Line 2	\$ _____	
Prior	11. Page 4 Line 3	\$ _____	
Year	12. Page 4 Line 18A	\$ _____	
Fourth	13. Page 4 Line 2	\$ _____	
Prior	14. Page 4 Line 3	\$ _____	
Year	15. Page 4 Line 18A	\$ _____	
Total	16. Sum of Lines 1-15	\$ _____	
Net Premium Earned			
Page 4	17. Current Year	\$ _____	
Line 1	18. Prior Year	\$ _____	
	19. Second Prior Year	\$ _____	
	20. Third Prior Year	\$ _____	
	21. Fourth Prior Year	\$ _____	
Total	22. Sum of Lines 17-21	\$ _____	
Five-Year Loss Ratio			
23. Line 16 ÷ Line 22		_____ %	

TEST 4 Work Sheet 3 FIVE-YEAR OPERATING RATIO

		_____ Company	
		_____ Year	
Underwriting Expenses			
Net of Other Income			
Current	1. Page 4 Line 4	\$ _____	
Year	2. Page 4 Line 5	\$ _____	
Statement	3. Page 4 Line 17	\$ _____	
	4. Line 1 + Line 2 - Line 3		\$ _____
Prior	5. Page 4 Line 4	\$ _____	
Year	6. Page 4 Line 5	\$ _____	
Statement	7. Page 4 Line 17	\$ _____	
	8. Line 5 + Line 6 - Line 7		\$ _____
Second	9. Page 4 Line 4	\$ _____	
Prior	10. Page 4 Line 5	\$ _____	
Year	11. Page 4 Line 17	\$ _____	
	12. Line 9 + Line 10 - Line 11		\$ _____
Third	13. Page 4 Line 4	\$ _____	
Prior	14. Page 4 Line 5	\$ _____	
Year	15. Page 4 Line 17	\$ _____	
	16. Line 13 + Line 14 - Line 15		\$ _____
Fourth	17. Page 4 Line 4	\$ _____	
Prior	18. Page 4 Line 5	\$ _____	
Year	19. Page 4 Line 17	\$ _____	
	20. Line 17 + Line 18 - Line 19		\$ _____
	21. Line 4 + Line 8 + Line 12 + Line 16 + Line 20		\$ _____
Net Premium Written			
Page 7	22. Current Year Statement	\$ _____	
Page 2C	23. Prior Year Statement	\$ _____	
Column 4	24. Second Prior Year	\$ _____	
Line 31	25. Third Prior Year	\$ _____	
	26. Fourth Prior Year	\$ _____	
	27. Sum of Lines 22-26		\$ _____
Five-Year Expense Ratio			
	28. Line 21 ÷ Line 27		_____

TEST 4 Work Sheet 4 FIVE-YEAR OPERATING RATIO

Note: This calculation is identical to Work Sheet 2 for Test 4A - the one-year operating ratio. The calculation of deferred acquisition expenses below is also included in Test 6 (Work Sheet 2).

	Invested Assets		Company	
			Year	
Total	1 Prior 2 Total Lines 1-7	\$ _____		\$ _____
	2 Page 1 Line 14	\$ _____		
	3 Line 1 + Line 2	\$ _____		
Stated Surplus	Adjusted Surplus			
Eq. Stat Ret	4 Prior 3 Line 27	\$ _____		\$ _____
Revenue Adjustment	5 Page 1 Line 16	\$ _____		\$ _____
	6 Test 6 Work Sheet Line 18	\$ _____		
	7 Test 10 Work Sheet Line 15	\$ _____		
	8 Test 11 Work Sheet Line 19	\$ _____		
	9 Average of Lines 6, 7 and 8*	\$ _____		
Deferred Acquisition Expense Adjustment	10 Page 10 Column 1 Line 22	\$ _____		
Total Und Expenses	11 Page 10 Column 2 Line 26	\$ _____		
Commissions	12 Page 10 Column 3 Line 18E	\$ _____		
License Renewal Fees	13 Line 10 - Line 11 - Line 12	\$ _____		
Other Und Expenses	14 Half of Line 13	\$ _____		
Acquisition Expenses	15 Line 11 + Line 12 + Line 14	\$ _____		
Premium Written	16 Page 7 Part 2C Column 4 Line 31	\$ _____		
Acq Expense Ratio	17 Line 15 ÷ Line 16	\$ _____		
Unearned Premium	18 Page 7 Part 2B Column 2 Line 31	\$ _____		
Deferred Acq Exp	19 Page 7 Part 2B Column 4 Line 31	\$ _____		
Adjusted Surplus	20 Page 7 Part 2B Column 5 Line 31	\$ _____		
	21 Line 18 + Line 19 + Line 20	\$ _____		
	22 Line 17 X Line 21	\$ _____		
	23 Line 4 + Line 5 - Line 9 + Line 22	\$ _____		
Policyholder Funds				
	24 Line 3 - Line 23	\$ _____		

* If more than one Test 6, 10, and 11 are not being completed, this revenue adjustment can easily be obtained by multiplying current year surplus (line 4 above) by the average of the results in Tests 6, 10, and 11, as provided in the current year's summary release.

TEST 4A Work Sheet 1 ONE-YEAR OPERATING RATIO

 Company

 Year

Note: If net premium earned (Line 6) or written (Line 11) is zero or negative, no test result is calculated.

Loss Ratio

- | | | | |
|-----------------------------|----|-------|--------|
| 1. Page 4 Line 2 | \$ | _____ | |
| 2. Page 4 Line 3 | \$ | _____ | |
| 3. Page 4 Line 18A | \$ | _____ | |
| 4. Line 1 + Line 2 + Line 3 | \$ | _____ | |
| 5. Page 4 Line 1 | \$ | _____ | |
| 6. Line 4 ÷ Line 5 | | | _____% |

Expense Ratio

- | | | | |
|-------------------------------------|----|-------|--------|
| 7. Page 4 Line 4 | \$ | _____ | |
| 8. Page 4 Line 6 | \$ | _____ | |
| 9. Page 4 Line 17 | \$ | _____ | |
| 10. Line 7 + Line 8 + Line 9 | \$ | _____ | |
| 11. Page 7 Part 2C Column 4 Line 31 | \$ | _____ | |
| 12. Line 10 ÷ Line 11 | | | _____% |

Investment Income Ratio

- | | | | |
|-----------------------------------|----|-------|--------|
| 13. Page 4 Line 8 | \$ | _____ | |
| 14. Work Sheet 2 Line 26 | \$ | _____ | |
| 15. Page 2 Total Lines 1-7 and 14 | \$ | _____ | |
| 16. Line 14 ÷ Line 15 | | | |
| 17. Line 13 X Line 16 | \$ | _____ | |
| 18. Page 4 Line 1 | \$ | _____ | |
| 19. Line 17 ÷ Line 18 | | | _____% |

Test Result

- | | | | |
|--------------------------------|--|--|--------|
| 20. Line 6 + Line 12 + Line 19 | | | _____% |
|--------------------------------|--|--|--------|

TEST 4A Work Sheet 2 ONE-YEAR OPERATING RATIO

Company _____

Year _____

Note: This calculation is identical to Work Sheet 4 for Test 4 — the five-year operating ratio. The calculation of deferred acquisition expenses below is also included in Test 6 (Work Sheet 2).

Invested Assets				
1	Page 2 Total Lines 1-7	\$ _____		
2	Page 2 Line 14	\$ _____		
3	Line 1 + Line 2	\$ _____		
Adjusted Surplus				
4	Page 3 Line 27	\$ _____		
5	Page 3 Line 18	\$ _____		
Stated Surplus				
Exc Stat Res.		\$ _____		
Reserve Adjustment				
6. Test 8 Work Sheet Line 18		\$ _____		
7. Test 10 Work Sheet Line 16		\$ _____		
8. Test 11 Work Sheet Line 19		\$ _____		
9. Average of Lines 6, 7 and 8*		\$ _____		
Deferred Acquisition Expense Adjustment				
10. Page 10 Column 2 Line 22		\$ _____		
11. Page 10 Column 2 Line 26		\$ _____		
12. Page 10 Column 2 Line 18E		\$ _____		
13. Line 10 - Line 11 - Line 12		\$ _____		
14. Half of Line 12		\$ _____		
15. Line 11 + Line 12 + Line 14		\$ _____		
16. Page 7 Part 2C Column 4 Line 31		\$ _____		
17. Line 15 + Line 16		\$ _____		
18. Page 7 Part 2C Column 2 Line 31		\$ _____		
19. Page 7 Part 2C Column 4 Line 31		\$ _____		
20. Page 7 Part 2C Column 5 Line 31		\$ _____		
21. Line 18 + Line 19 + Line 20		\$ _____		
22. Line 17 X Line 21		\$ _____		
23. Line 4 + Line 5 - Line 9 + Line 22		\$ _____		
Policyholder Funds				
24. Line 3 - Line 23		\$ _____		
Total		\$ _____		
Unearned Premium				
Deferred Acq. Exp.		\$ _____		
Adjusted Surplus		\$ _____		

* If work sheets for Tests 8, 10, and 11 are not being completed, this reserve adjustment can easily be obtained by multiplying current year surplus (Line 4 above) by the average of the results on Tests 8, 10, and 11 as provided in the current year's summary returns.

TEST 5 INVESTMENT YIELD

 Company

 Year
Net Investment Income

1. Page 4 Line B

\$ _____

Average Invested Assets**Current Annual Statement**

2. Page 2 Total for Lines 1-7

\$ _____

3. Page 2 Line 14

\$ _____

4. Page 3 Line 8

\$ _____

5. Line 2 + Line 3 - Line 4

\$ _____

Prior Annual Statement

6. Page 2 Total for Lines 1-7

\$ _____

7. Page 2 Line 14

\$ _____

8. Page 3 Line 8

\$ _____

9. Line 6 + Line 7 - Line 8

\$ _____

Net Investment Income

10. Page 4 Line B, Current Year

\$ _____

11. Line 5 + Line 9 - Line 10

\$ _____

12. Half of Line 11

\$ _____

Investment Yield

13. Line 11 ÷ Line 12

_____ %

TEST 6 Work Sheet 1 CHANGE IN SURPLUS

Company_____
Year

Note: If current year adjusted surplus (Line 8 below) is zero or negative, test result is -99 percent. If current year adjusted surplus is positive but prior year adjusted surplus (Line 13) is zero or negative, test result is 99 percent.

**Current Year
Adjusted Surplus**

Stated Surplus	1 Page 3 Line 27	\$ _____
Exc Stat Res.	2 Page 3 Line 16	\$ _____
	3 Test 9 Work Sheet Line 18	\$ _____
	4 Test 10 Work Sheet Line 15	\$ _____
	5 Test 11 Work Sheet Line 19	\$ _____
Res. Adjustment	6 Average of Line 3, 4, and 5*	\$ _____
Def. Adj. Exp.	7 Work Sheet 2 Line 13 (current year)	\$ _____
	8 Line 1 + Line 2 - Line 6 + Line 7	\$ _____

**Prior Year
Adjusted Surplus**

Stated Surplus	9 Page 3 Line 27 Prior Year	\$ _____
Exc. Stat. Res.	10 Page 3 Line 16, Prior Year	\$ _____
Res. Adjustment	11 Test 9 Work Sheet Line 18**	\$ _____
Def. Adj. Exp.	12 Work Sheet 2 Line 13 (prior year)	\$ _____
	13 Line 9 + Line 10 - Line 11 + Line 12	\$ _____

Change in Surplus

14 Line 8 - Line 13	\$ _____
---------------------	----------

Test Result

15 Line 14 ÷ Line 13	_____ %
----------------------	---------

* If work sheets for Tests 9, 10, and 11 are not being completed, this reserve adjustment can easily be obtained by multiplying current year surplus (Line 1 above) by the average of the results on Tests 9, 10, and 11, as provided in the current year's summary releases.

** This one-year reserve development may also be obtained by multiplying current year surplus (Line 1 above) by the current Test 9 result.

TEST 4 Work Sheet 2 CHANGE IN SURPLUS

Note: Deferred acquisition expenses for the current year are also calculated for Part 4 (in Work Sheet 4) and Part 6A (in Work Sheet 2).

	Current Year Annual Statement	Prior Year Annual Statement
Total Unq. Expenses	\$ _____	\$ _____
Commissions	\$ _____	\$ _____
Taxes, Licenses, Fees	\$ _____	\$ _____
Other Unq. Expenses	\$ _____	\$ _____
Acquisition Expenses	\$ _____	\$ _____
Premium Written	\$ _____	\$ _____
Avq. Emp. Ratio	\$ _____	\$ _____
Unearned Premium	\$ _____	\$ _____
Def. Acq. Exp.	\$ _____	\$ _____

Deferred Acquisition Expenses

1 Page 10 Column 2 Line 22

2 Page 10 Column 2 Line 2F

3 Page 10 Column 2 Line 10E

4 Line 1 - Line 3 - Line 3

5 Half of Line 4

6 Line 2 + Line 3 + Line 5

7 Page 7 Part 2C Column 4 Line 31

8 Line 6 ÷ Line 7

9 Page 7 Part 2B Column 2 Line 31

10 Page 7 Part 2B Column 4 Line 31

11 Page 7 Part 2B Column 5 Line 31

12 Line 9 + Line 10 + Line 11

13 Line 8 X Line 12

Company _____
Year _____

TEST 7 LIABILITIES TO LIQUID ASSETS

		Company	
		Year	
Adjusted Liabilities			
1	Page 2 Line 23	\$	
2	Page 3 Line 16	\$	
3	Test 9 Work Sheet Line 18	\$	
4	Test 10 Work Sheet Line 16	\$	
5	Test 11 Work Sheet Line 18	\$	
6	Average of Lines 3, 4 and 5*	\$	
7	Line 1 - Line 2 + Line 6	\$	
Liquid Assets			
8	Page 2 Total for Lines 1, 7 and 14	\$	
9	Page 2 Line 4, 1	\$	
10	Page 2 Line 4, 2	\$	
11	Line 8 + Line 10	\$	
12	8% of Line 7	\$	
13	Line 11 - Line 12 if Positive**	\$	
14	Schedule D Summary Page	\$	
	Column G Line 29	\$	
15	Schedule D Summary Page	\$	
	Column J Line 47	\$	
16	Schedule D Summary Page	\$	
	Column K Line 65	\$	
17	Line 14 + Line 15 + Line 16	\$	
18	Line 8 - Line 13 - Line 17	\$	
Test Result			
19	Line 7 + Line 18	\$	
20		\$	
21		\$	
22		\$	
23		\$	
24		\$	
25		\$	
26		\$	
27		\$	
28		\$	
29		\$	
30		\$	
31		\$	
32		\$	
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92		\$	
93		\$	
94		\$	
95		\$	
96		\$	
97		\$	
98		\$	
99		\$	
100		\$	

* If none shown for Page 8, 10, and 11 are not being completed, this reserve adjustment can easily be obtained by multiplying current year surplus (annual statement Page 2 Line 27) by the average of the results on Test 8, 10, and 11, as provided in the current year's summary column.

** If Line 12 is greater than Line 11, then give Line 12 as zero.

TEST 8 AGENTS' BALANCES TO SURPLUS

Company

Year

Agents' Balances

1 Page 2 Line 6 \$_____

Surplus

2 Page 3 Line 27 \$_____

Test Result

3 Line 1 + Line 2 _____%

TEST 9 ONE-YEAR RESERVE DEVELOPMENT TO SURPLUS

Company

Year

Note: For members of groups or fleets with pooling agreements, the calculation of reserve development is made on a consolidated basis. The total reserve development calculated in Line 16 is then multiplied by the company's current year pool percentage (Line 17) to determine the amount of reserve development assigned to the individual company (Line 18). For companies without pooling agreements, Line 18 is equal to Line 16 below.

**One-Year Reserve
Development**
Property Lines

1. Schedule O Column 1B Line 31 \$ _____
2. Schedule O Column 5 Line 31 \$ _____
3. Schedule O Column 5 Line 31 \$ _____
4. Schedule O Column 7 Line 31 \$ _____
5. Line 2 + Line 3 + Line 4 \$ _____
6. Line 1 - Line 5 \$ _____

Liability Lines
**Column for Current Year
Line Above Current Year**

7. Schedule P Part 3A \$ _____
8. Schedule P Part 3B \$ _____
9. Schedule P Part 3C \$ _____
10. Line 7 + Line 8 + Line 9 \$ _____

**Column for Prior Year
Line Above Current Year**

11. Schedule P Part 3A \$ _____
12. Schedule P Part 3B \$ _____
13. Schedule P Part 3C \$ _____
14. Line 11 + Line 12 + Line 13 \$ _____
15. Line 10 - Line 14 \$ _____

Total

16. Line 6 + Line 15 \$ _____
17. Current Year Pool Percentage _____ %
18. Line 16 X Line 17 \$ _____

Surplus

19. Page 3 Line 27 \$ _____

Test Result

20. Line 18 + Line 19 _____ %

TEST 10 TWO-YEAR RESERVE DEVELOPMENT TO SURPLUS

Company

Year

Note: For members of groups or fleets with pooling agreements, the calculation of reserve development is made on a consolidated basis. The total reserve development calculated in Line 13 is then multiplied by the company's current year pool percentage (Line 14) to determine the amount of reserve development assigned to the individual company (Line 15). For companies without pooling agreements, Line 15 is equal to Line 13 below.

Two-Year Reserve Development

Property Lines

1. Schedule O Column 19 Line 31 \$ _____
2. Schedule O Column 7 Line 31 \$ _____
3. Line 1 - Line 2 \$ _____

Liability Lines

Column for Current Year
Line Above Prior Year

4. Schedule P Part 3A \$ _____
5. Schedule P Part 3B \$ _____
6. Schedule P Part 3C \$ _____
7. Line 4 + Line 5 + Line 6 \$ _____

Column for Second Prior Year
Line Above Prior Year

8. Schedule P Part 3A \$ _____
9. Schedule P Part 3B \$ _____
10. Schedule P Part 3C \$ _____
11. Line 8 + Line 9 + Line 10 \$ _____
12. Line 7 - Line 11 \$ _____
- Total \$ _____
13. Line 3 + Line 12 \$ _____
14. Current Year Pool Percentage _____ %
15. Line 13 X Line 14 \$ _____

Surplus

16. Page 3 Line 27 \$ _____

Test Result

17. Line 15 - Line 16 _____ %

TEST 11 ESTIMATED CURRENT RESERVE DEFICIENCY TO SURPLUS

		<u> </u> Company	
		<u> </u> Year	
Developed Reserves to Premium: Prior Year			
1. Page 3 Line 1, Prior Year	\$	<u> </u>	
2. Page 3 Line 2, Prior Year	\$	<u> </u>	
3. Test 9 Work Sheet Line 18*	\$	<u> </u>	
4. Line 1 + Line 2 + Line 3			\$ <u> </u>
5. Page 4 Line 1, Prior Year			\$ <u> </u>
6. Line 4 ÷ Line 5			<u> </u> %
Developed Reserves to Premium: Second Prior Year			
7. Page 3 Line 1, Second Prior Year	\$	<u> </u>	
8. Page 3 Line 2, Second Prior Year	\$	<u> </u>	
9. Test 10 Work Sheet Line 15**	\$	<u> </u>	
10. Line 7 + Line 8 + Line 9			\$ <u> </u>
11. Page 4 Line 1, Second Prior Year			\$ <u> </u>
12. Line 10 ÷ Line 11			<u> </u> %
Estimated Current Deficiency (Redundancy)			
13. Average of Line 6 and Line 12		<u> </u>	
14. Page 4 Line 1, Current Year	\$	<u> </u>	
15. Line 13 X Line 14			\$ <u> </u>
16. Page 3 Line 1, Current Year	\$	<u> </u>	
17. Page 3 Line 2, Current Year	\$	<u> </u>	
18. Line 16 + Line 17			\$ <u> </u>
19. Line 15 ÷ Line 18			\$ <u> </u>
Surplus			
20. Page 3 Line 27, Current Year			\$ <u> </u>
Test Result			
21. Line 19 ÷ Line 20			<u> </u> %

* If the work sheet for Test 9 is not being completed, this one-year reserve deficiency can easily be obtained by multiplying current year surplus (annual statement Page 3 Line 27) by the result on Test 9, as provided in the current year's summary releases.

** Like the one-year reserve deficiency, this two-year reserve deficiency can be obtained by multiplying current year surplus by the current result on Test 10.

EXHIBIT 1

APPENDIX B

NEW TESTS EVALUATED

NUMBER	NAME	FORMULA
21	Investment yield	$\frac{\text{Net investment income}}{\text{Average invested assets}}$
22	Change in writings	$\frac{\text{Net premium written (current year - prior year)}}{\text{Net premium written (prior year)}}$
23	Liabilities to surplus	$\frac{\text{Liabilities}}{\text{Surplus}}$
24	Stock to assets	$\frac{\text{Common plus preferred stock}}{\text{Admitted assets}}$

RECENT IMPROVEMENTS IN THE EARLY WARNING SYSTEM

In January 1974, a number of improvements were made in the Early Warning System. This appendix describes these improvements, which are also reflected in the text of this users' manual. Since this appendix has been prepared for those who used the previous system and want to know the reasons behind the changes, it presumes a familiarity with the old solvency tests. Those who are using the Early Warning System for the first time this year may use the users' manual without reference to this appendix.

The recent improvements in the Early Warning System fall into six categories:

1. Changing the group of tests
2. Simplifying formulas
3. Setting bench marks
4. Selecting priority companies
5. Improving report format
6. Updating the users' manual.

The first five of these categories are discussed below.

CHANGING THE GROUP OF TESTS

In addition to the eleven tests in the prior system, we analyzed four potential new tests -- investment yield, change in writings, liabilities to surplus, and stock to assets (Exhibit II). Our analysis was based on the test results for all companies in 1972 (for the new tests, results were calculated for a stratified sample of 200 companies closely matching the total population in distribution of scores on the old tests). In addition, test results were

EXHIBIT III

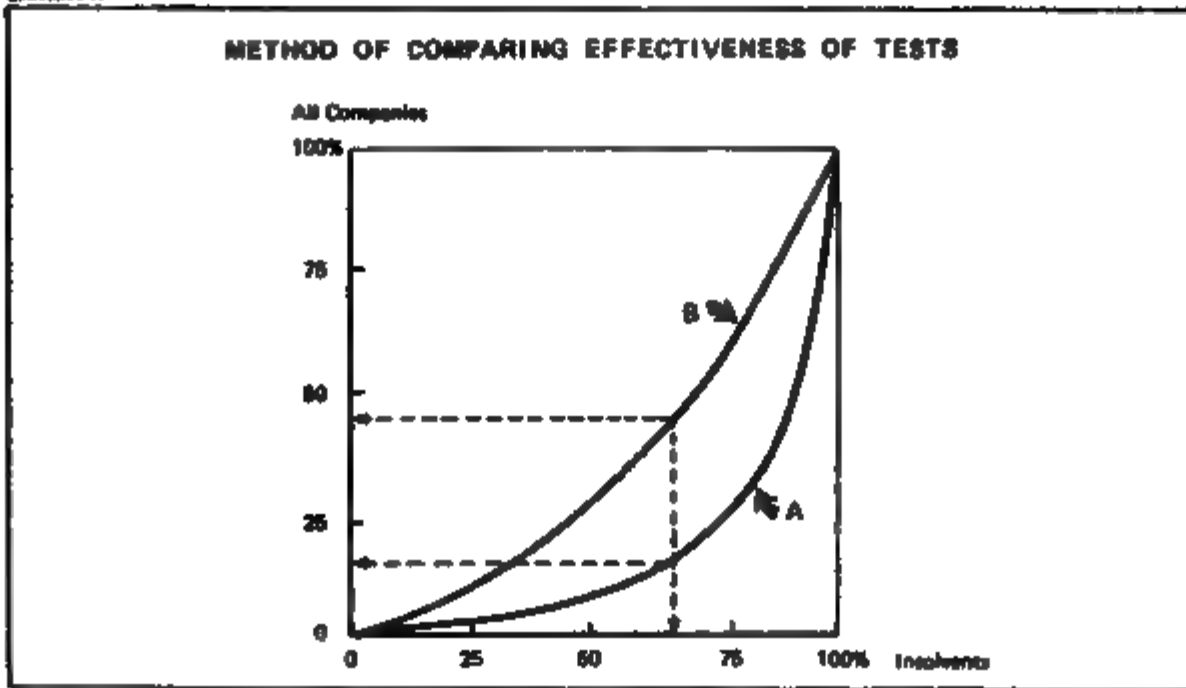
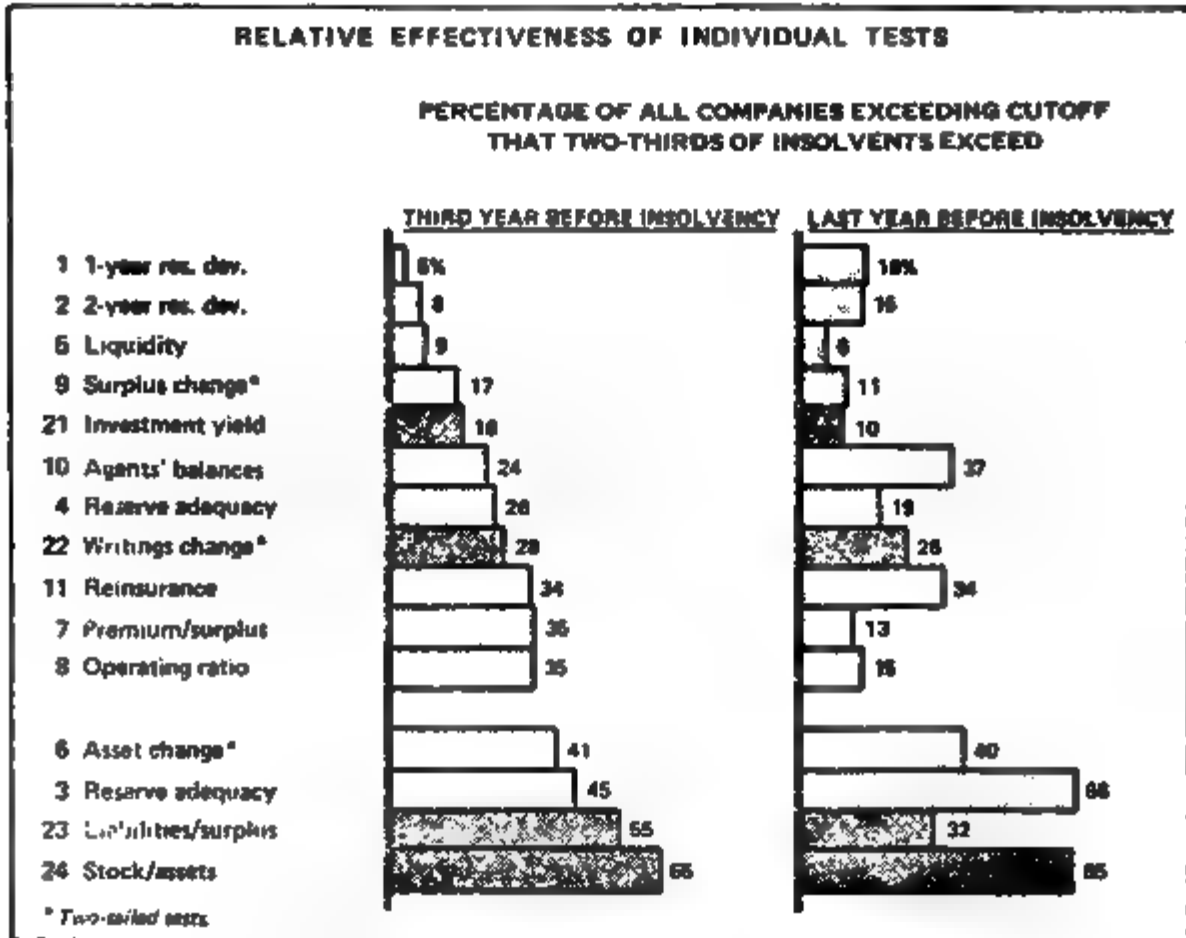


EXHIBIT III



calculated for a sample of 37 insolvent companies for periods up to five years before insolvency. This sample includes all insolvent companies for which copies of annual statements were available (with the exception of one company that was liquidated at the owner's request) and represents approximately half of the companies becoming insolvent from 1966 through 1972.

The objective of our analysis was to determine the relative effectiveness of the various tests in discriminating between sound and troubled companies. This relative effectiveness was determined in the following manner: For each test, a variety of scores spanning the range of possible scores was selected. For each score, the percentage of all companies and of insolvent companies with test results higher than the chosen score was determined, and these pairs of related percentages were plotted graphically. The line formed by the plotted points, such as line A in Exhibit II, represents the discriminating effectiveness of the test. Of course, the closer this line comes to the point representing 100 percent of insolvents and zero percent of all companies (that is, the less area under the curve), the more discriminating the test. Thus, test A in Exhibit II is more effective than test B, this judgment can be made without regard to any particular benchmark score. Finally, if lines A and B represent the same test, but with insolvent company results taken at different intervals before insolvency, a judgment can be formed whether the test increases in effectiveness as the company approaches insolvency.

Given this analysis, the relative effectiveness of a large number of tests can be represented by a bar graph showing the percentage of all companies with test results worse than a cutoff score which fails a given percentage of insolvent companies. The bars on the graph will be the same length as the vertical dotted line on Exhibit II. Such a summary graph is presented as Exhibit III, where the eleven old and four new tests are ranked in order of their effectiveness three years prior to insolvency. (Throughout this appendix, all test numbers refer to the old sequence of tests.) Examination of Exhibit III yields the following conclusions:

1. The most effective tests, both three and one year prior to insolvency, are the tests of reserve development, liquidity, surplus change and investment yield. We added the investment yield test to the group of tests.
2. The change in writings test is moderately effective in both years. More importantly, this test tends to identify insolvent companies not identified by the other tests. We also added this test to the group.

EXHIBIT IV

Investment yield is a highly effective test . . .

All Companies

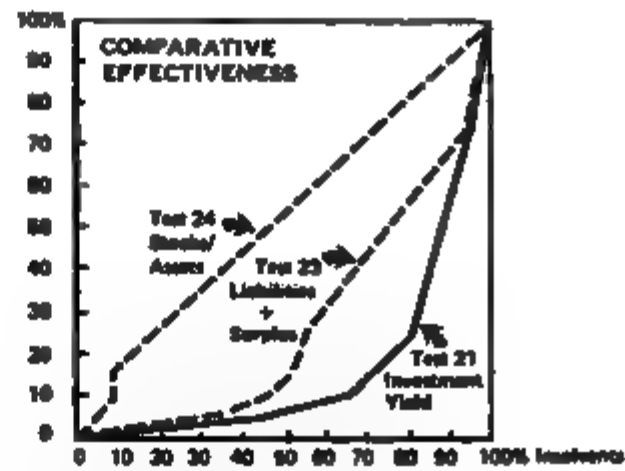


EXHIBIT V

Change in writings is a moderately effective test, with both high and low scores distinguishing troubled companies . . .

All Companies

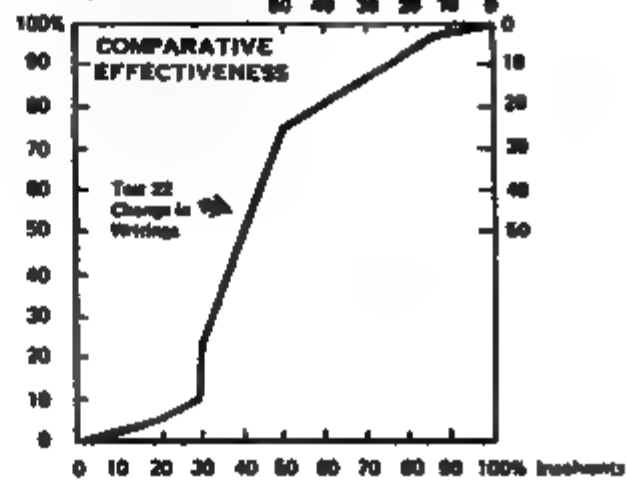
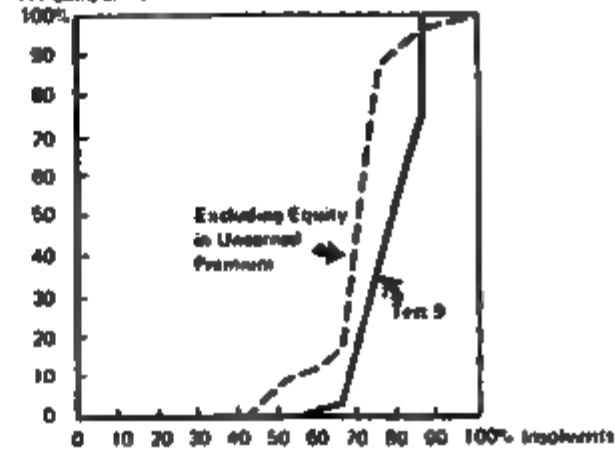


EXHIBIT VI

Excluding adjustments for equity in unearned premium decreases effectiveness of Test 9 . . .

TEST 9 CHANGE IN SURPLUS
All Companies



3. The least effective tests in both years are asset change, estimated reserve adequacy (Test 3) and stocks to assets. We dropped these tests.
4. The liabilities to surplus test shows moderate effectiveness immediately prior to insolvency. However, it is relatively ineffective three years before insolvency and tends to catch companies which also fail a number of other tests. Therefore, we did not adopt it.
5. The premium to surplus and operating ratios become significantly more indicative as companies approach insolvency. When test results for all companies over an adequate period of time become available, therefore, we intend to evaluate the use of trends in these ratios.

A more extensive view of the relative effectiveness of the four new tests is provided in Exhibits IV and V. Note that on the change in writings test in Exhibit V, both high and low scores indicate a probability that the company is troubled.

SIMPLIFYING FORMULAS

Many states have cited the complexity of the test formulas as a principal reason for not using the Early Warning System. One example of this complexity is the adjustment for equity in unearned premium in the ratios of liabilities to liquid assets, premium to surplus, and prior-year surplus to current surplus. Therefore, we believe these adjustments should be retained only if they materially improve the effectiveness of the tests.

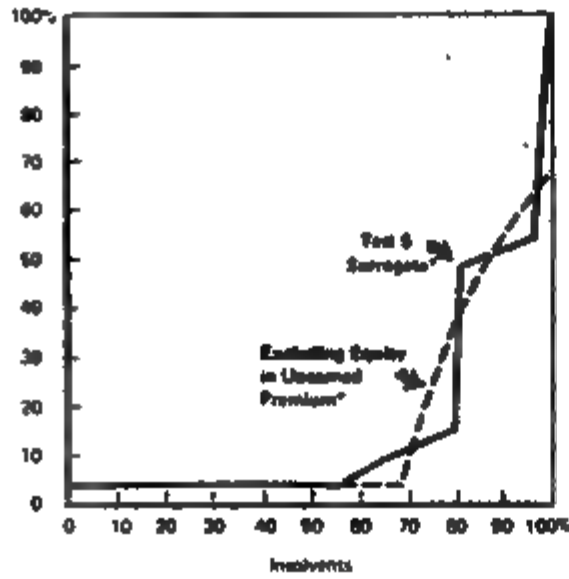
Adjustment of surplus for equity in unearned premium does materially improve the effectiveness of the change in surplus ratio (Exhibit VI). Because a number of sound, growing companies are investing surplus in the acquisition of business, a surplus change ratio that does not adjust surplus to include these deferred acquisition expenses catches a higher percentage of all companies than the current ratio, which adjusts surplus to include equity in unearned premium. We therefore retained this adjustment in the surplus change test.

EXHIBIT VII

Excluding adjustment for equity in unearned premium does not affect effectiveness of Tests 5 and 7 . .

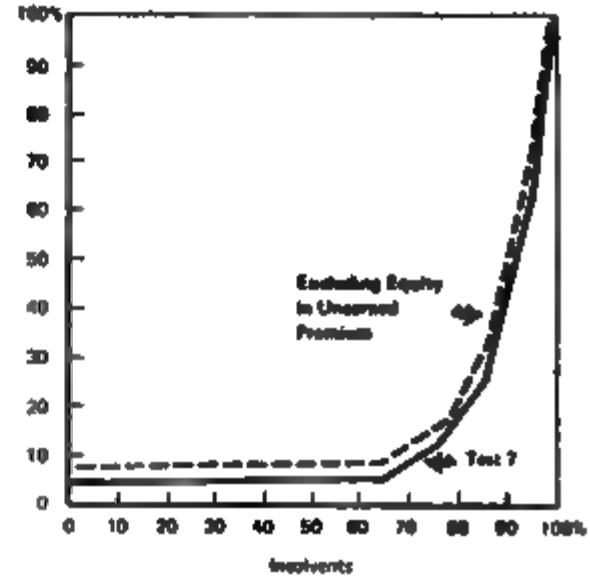
TEST 5: LIQUIDITY RATIO

All Companies



TEST 7: PREMIUM TO SURPLUS

All Companies



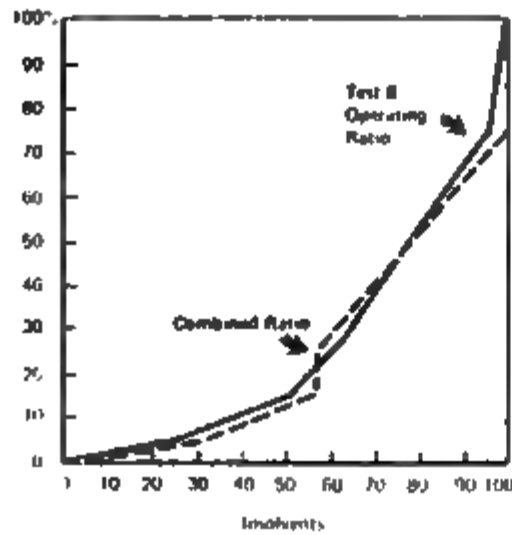
The surrogate differs from the actual test in using cash and invested assets as the denominator in place of "liquid assets". This is also the case for the formula excluding equity in unearned premium.

EXHIBIT VIII

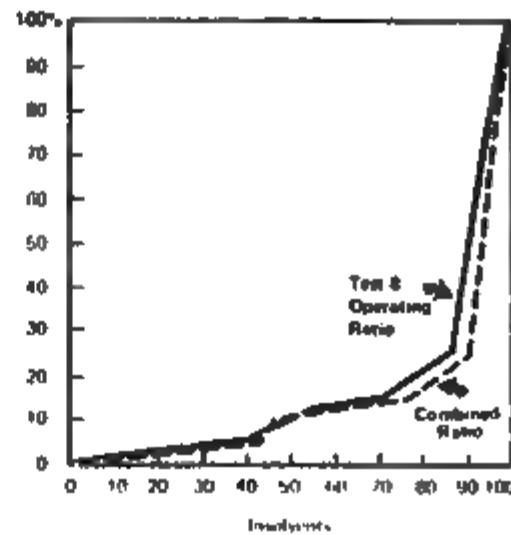
Operating and combined ratios are equally effective in distinguishing sound and troubled companies . .

THREE YEARS BEFORE
INSOLVENCY

All Companies

YEAR BEFORE
INSOLVENCY

All Companies



The adjustment, however, does not significantly alter the effectiveness of the ratios of liabilities to liquid assets or premium to surplus (Exhibit VII). This fact appears consistent with the following logic:

1. In the ratio of liabilities to liquid assets, liabilities had been reduced by the amount of equity in unearned premium. Logically, equity in unearned premium should not be deducted from liabilities, but added to assets as deferred acquisition expense. This asset, however, is not liquid. Thus, the adjustment for equity in unearned premium is not appropriate in either the numerator or the denominator of the ratio of liabilities to liquid assets.
2. The premium to surplus ratio measures the amount of cushion supplied by surplus to absorb fluctuations in loss experience, which are related to the level of premium written. Not being liquid, investments in deferred acquisition expenses cannot be drawn upon to pay large losses. Although these investments do increase the value of the business as a going concern, and thus facilitate obtaining additional capital, this recourse is frequently not available to companies faced with potential insolvency.

For these reasons, we dropped the adjustment for equity in unearned premium from the liabilities to liquid assets and premium to surplus ratios.

A second simplification involved the surplus change test. This test (Number 9) had been calculated as prior year surplus divided by current year surplus, in order to have a decrease in surplus be indicated by a positive test result. On the old tests, all large positive results were "bad." However, since the investment yield test has been added, this is no longer the case. So we made the change in surplus test easier to work with by making it: the change in surplus divided by prior year surplus.

We also considered modifying the operating ratio by removing the adjustment for investment income, essentially converting the formula to a combined ratio. This change would significantly simplify the formula without diminishing the effectiveness of the test (Exhibit VIII). We concluded, however, that the operating ratio is a logically more adequate measure of profitability than the combined ratio and retained it. Some of the improvements in the users' manual have been aimed at making this test easier to understand.

Our final modification in the test formulas concerned the reinsurance test. As Exhibit II shows, the reinsurance test is the least effective of the eleven new tests, when both the first and third years prior to insolvency are considered. This lack of effectiveness may be related to the dual nature of the reinsurance test, which was intended to measure both funds held by

EXHIBIT 12

On the investment yield test, a cutoff of 3.5 percent would have caught:

- 75 percent of insolvents
- Less than 20 percent of all companies

All Companies

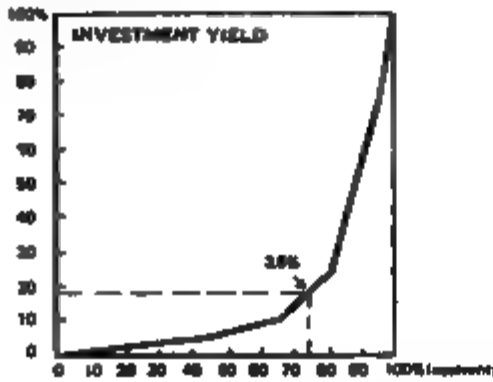


EXHIBIT 13

Bench mark: 33 percent on change in writings would catch:

- 45 percent of insolvents
- 18 percent of all companies

All Companies

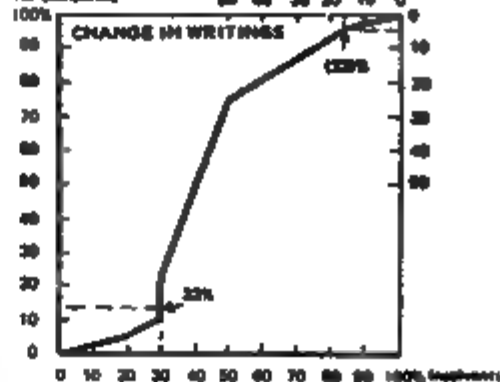


EXHIBIT 14

Bench marks on reserve tests were raised from 10 percent to 25 percent.

RESERVE TESTS

DISTRIBUTION OF COMPANIES SCORING 10 PERCENT OR MORE

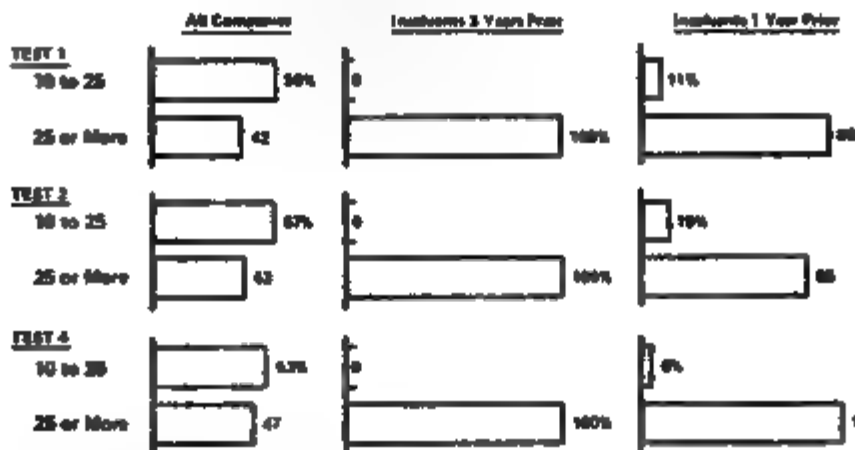
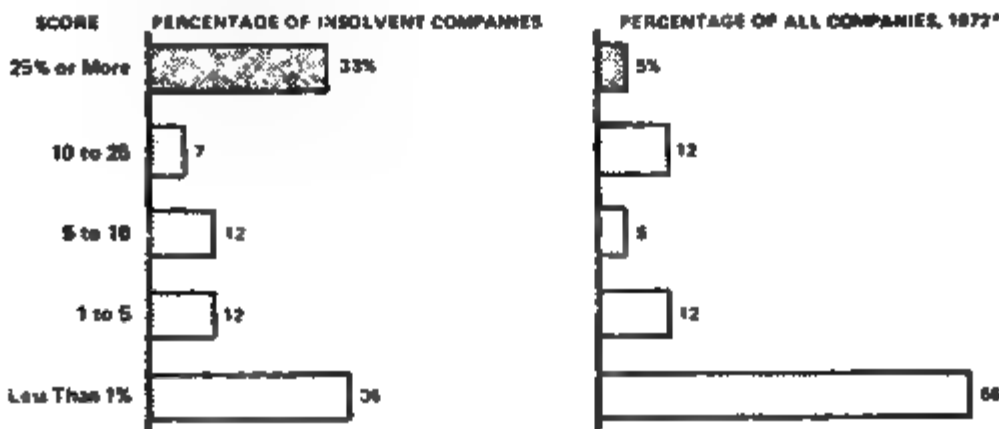


EXHIBIT 15

Bench mark on surplus and test was established at 25 percent



* Based on a sample of 100 companies.

reinsurers (reinsurance receivable on paid and unpaid claims) and surplus aid (as measured by the ceding commissions in unearned reinsurance premium for nonaffiliates). Since surplus aid is the primary concern, we modified the formula to exclude from the numerator reinsurance receivable on paid and unpaid claims.

SETTING BENCH MARKS

On the new investment yield test, we established the acceptable or "usual" range as being above 3.5 percent. Seventy-five percent of insolvent companies scored below this cutoff in the year prior to insolvency, but less than 20 percent of all companies did so in 1972 (Exhibit IX). On the new test of change in writings, we established an acceptable range from minus 33 percent to 33 percent, which would have identified 45 percent of insolvents and 18 percent of all companies (Exhibit X).

We also changed the bench marks on the three remaining reserve tests from 10 percent to 25 percent. This change would have reduced the number of companies identified by each test in 1972 by more than half. However, it would not have permitted any more insolvent companies to pass these tests 3 years prior to insolvency, and in the year prior to insolvency the few companies scoring between 10 percent and 25 percent on the reserve tests were outside the usual range on many other tests (Exhibit XI).

Of the four ratios for which the formulas were modified, two require a corresponding adjustment in the bench mark. On the surplus aid test, we established a bench mark of 25 percent, which would have identified 33 percent of insolvent companies in the year prior to insolvency, but only 5 percent of all companies in 1972 (Exhibit XII). The rearrangement of the change in surplus test requires translation of the old bench marks to minus 10 percent and 50 percent. The other two modified tests retain their former bench marks. Retaining the old bench mark of 100 percent on the simplified ratio of liabilities to liquid assets will increase the percentage of all companies identified by only five points, from 8 percent to 13 percent. Retaining the old 300 percent bench mark on the simplified premium to surplus ratio will increase the percentage of companies identified by only three points, from 14 percent to 17 percent.

SELECTING PRIORITY COMPANIES

In order to develop a method of selecting priority companies for examination, we studied the way in which several task force members use and

EXHIBIT XIV

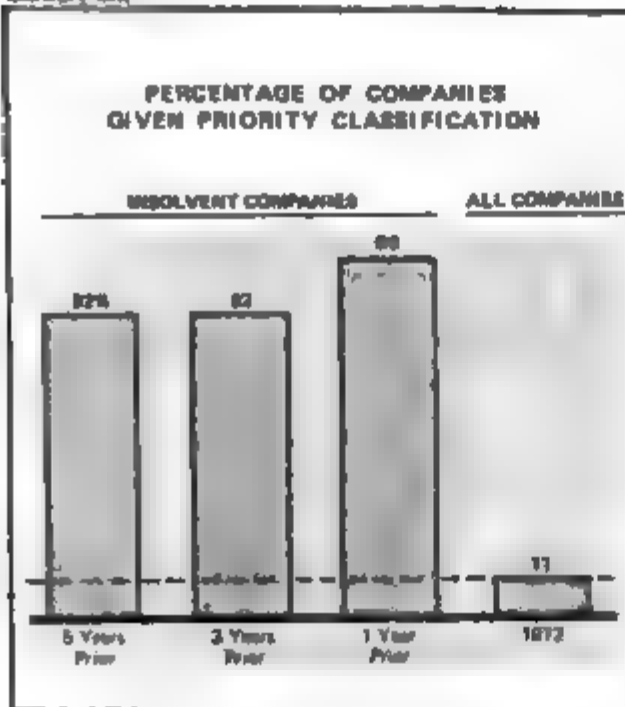


EXHIBIT XV

The "Four-of-Eleven" rule is the most effective in separating insolvent and sound companies

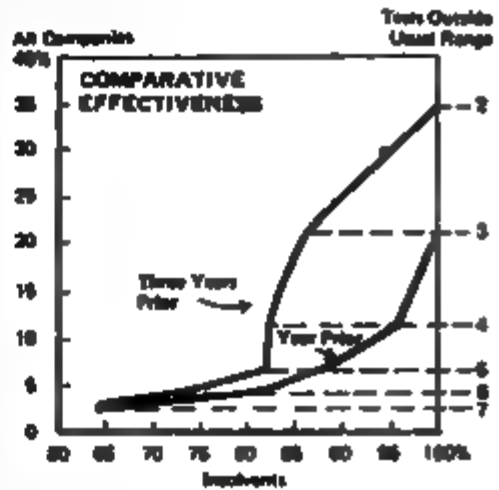


EXHIBIT XVI

TEST SCORES FOR INSOLVENT COMPANIES NOT IDENTIFIED BY SCREENING SYSTEM

TEST	THREE YEARS BEFORE INSOLVENCY				YEAR BEFORE
	NAAME INSURANCE	MEMBERS INSURANCE	UNITED SAVING	WORKMEN'S AND SUFFOLK	CITIZEN'S CASUALTY
1 1-year res. def.	(2)	8	(76)	1	(30)
2 2-year res. def.	1	(30)	(99)	(11)	(125)
4 Est. res. def.	(5)	(16)	(99)	(4)	(98)
5 Liquidity	56	76	38	42	74
7 Premium/surplus	141	111	128	87	6
8 Operating	95	(112)	94	(103)	73
9 Surplus change	77	105	87	103	(186)
10 Agents' balances	13	32	22	15	4
11 Reinsurance	9	68	(191)	82	68
21 Investment yield	(2.4)	4.1	(1.5)	(2.7)	4.0
22 Writings change	(98)	6	6	(55)	(196)

Circles indicate tests outside the usual range.

interpret the test results, as well as examining the patterns of test scores produced by insolvent and sound companies. Three principal conclusions emerged:

1. Most insolvent companies fell outside the usual range on many tests by wide margins.
2. Experienced users base their evaluation more on the number of tests on which the company fell outside the usual range than on the amount by which test results exceeded the bench marks or
* on the particular combination of test scores.
3. Although each user considers some tests more important than others, there is little agreement on relative priorities - except that the reserve tests, taken as a group, are important.

In addition, we tested the effectiveness of a wide variety of screening systems, which varied in the number of tests included, the bench marks used, and the complexity of the scoring system. For each approach tested, we calculated the percentage of all companies that would be classified as priority companies in 1972 and compared this with the percentage of insolvent companies that would have been so classified one and three years prior to insolvency. Our conclusion was that one of the simplest and most straightforward screening systems is the most effective: the number of tests on which the company fell outside the usual range.

We decided that the priority designation would be given to those companies falling outside the usual range on four or more of the eleven new tests at the new bench marks. This system would have classified as priority companies approximately 11 percent of all companies, as compared with 82 percent of insolvent companies in the third year prior to insolvency and 96 percent of insolvent companies in the year prior to insolvency (Exhibit XIII). Test results for the insolvent companies not identified by this system are shown in Exhibit XIV. Of four companies not identified three years prior to insolvency, two (Members and United Bonding) had changes in ownership or management during their last three years. Citizen's Casualty, which would not have been identified in its last year, was clearly identified by the system five years before insolvency (by seven tests) and three years before insolvency (by nine tests).

Exhibit XV shows the percentage of all companies and of insolvent companies falling outside the usual range on two to seven tests. The four-test rule for selecting priority companies provides the best balance between insolvent and solvent companies. If the rule were tightened to pick up

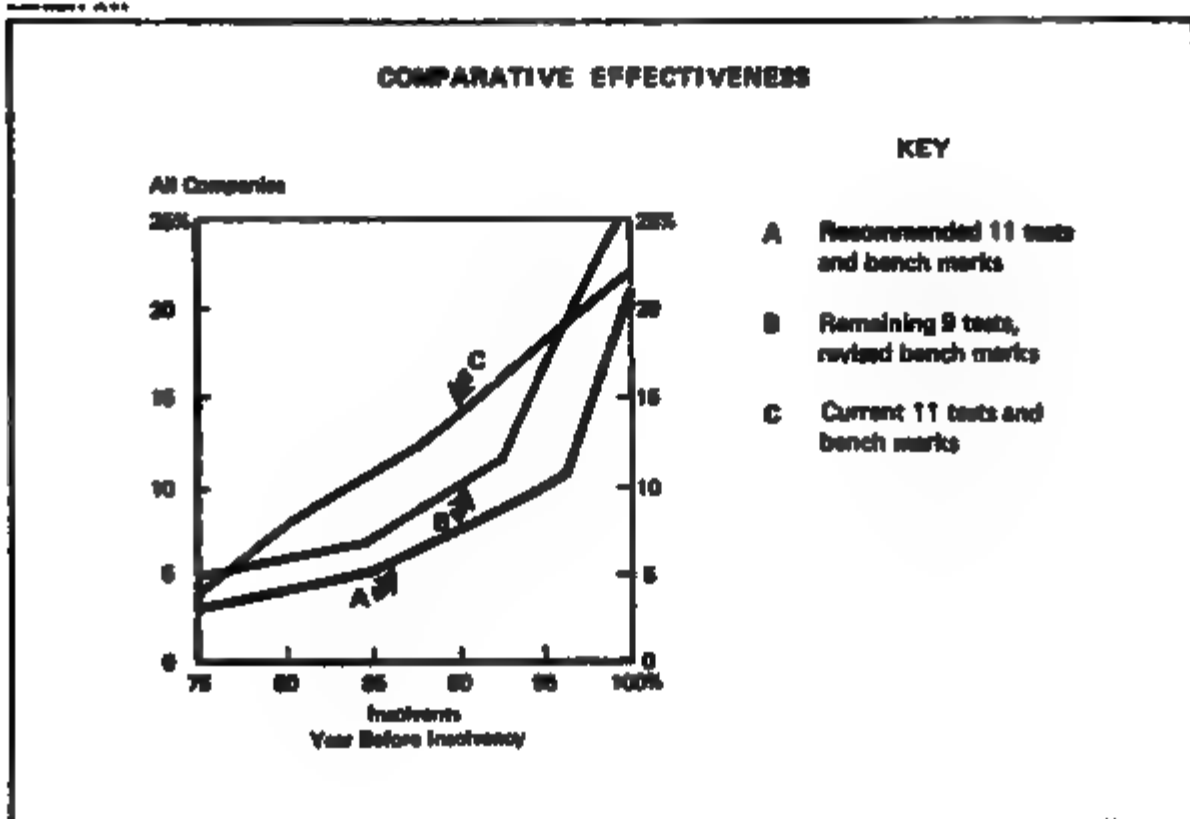
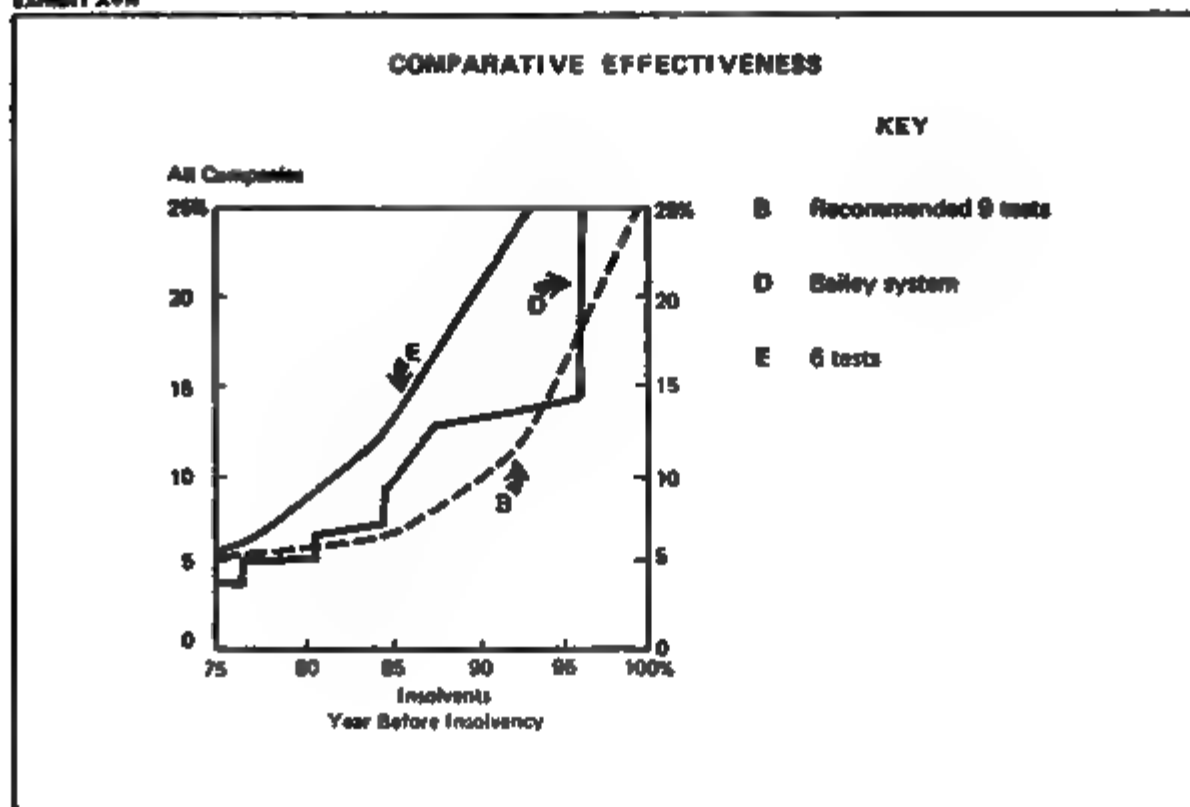


EXHIBIT XXV



companies with three or more scores outside the usual range, the percentage of all companies identified would almost double, with little increase in the percentage of insolvent companies identified. On the other hand, loosening the standard to five tests would reduce the percentage of insolvents identified in their last year by almost 10 points.

Exhibit XVI compares the effectiveness of this new system with a system based on the eleven old tests and bench marks. About half the improvement in effectiveness - as indicated by the distance from line C to line A in Exhibit XVI - is due to the two new tests (investment yield and change in writings), while the other half of the improvement is due to eliminating two of the old tests (asset change and reserve adequacy Test 3) and changing the bench marks on the remaining reserve tests from 10 percent to 25 percent.

The new screening system is compared to more complex and more simple systems in Exhibit XVII. The dotted line, which is the same as line B in Exhibit XVI, represents the chosen system without the two new tests. Line D represents the Bailey scoring system, under which from one to five points is assigned for each test result outside the usual range, depending on the amount by which the test result exceeded the bench mark. This system would, on balance, be only slightly less effective than the chosen system, but it would also be significantly more complex. Line E represents a typical screening system based on a smaller number of tests (old Tests 1, 2, 4, 5, 7, and 8). It is significantly less effective than the chosen system. No system involving a reduced number of tests was found to be more effective than the chosen system, which uses all eleven tests.

IMPROVING REPORT FORMAT

In order to make the early warning reports easier to understand and use, we decided that summary reports would be produced specifically for each state, and that companies would be listed in the following groups:

- § Priority domestic companies
- § Priority foreign companies
- § Nonpriority domestic companies
- § Nonpriority foreign companies.

Thus, each state would receive an action-oriented document tailored to its own requirements. In addition, we decided that the report should identify the name and usual range for each test and that all scores falling outside the usual range should be indicated by an asterisk.

In addition to a more action-oriented summary report, the states will also receive a data sheet on each priority company, which will provide:

- 1 Test results for three years
- 1 A breakdown of the four more complex tests into their component parts
- 1 Key annual statement information.

This data sheet is intended to assist the states in analyzing test results and preparing for examination of priority companies. The provision of three-ring binders will permit the states to insert each new summary release and priority company data sheet in its proper place as it is received.

IMPROVING THE LIFE AND HEALTHEARLY WARNING SYSTEMNATIONAL ASSOCIATION OF INSURANCE COMMISSIONERSTABLE OF CONTENTS

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Appendixes

- A - Specifications for Recommended Tests
- B - Adjusted Earnings and Balance Sheet Tests

PREFACE

This report contains two documents. The first, Improving the Life and Health Early Warning System, presents our recommendations for improving the system in two phases, for implementation in 1974 and 1975. The second, Using the Life and Health Early Warning System, is a draft user's manual to accompany the recommended system.

The manual's first chapter and appendix would be suitable, as written, for use during the current year. For use in 1975, after the recommended system is completely implemented, this draft manual can be finalized by substituting information on the 1973 test results of all companies for the references and exhibits showing data for a sample of solvent companies in 1972.

IMPROVING THE LIFE AND HEALTHEARLY WARNING SYSTEMNATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

This report presents our recommendations for improving the Early Warning System for life and health insurance companies. These recommendations are based on analysis discussed with the NAIC Task Force and Industry Advisory Committee in Chicago on March 18, 1974. In making these recommendations, we have given consideration to a number of suggestions made by the task force members and advisors at that meeting. The recommendations, however, are our own; they are not intended to represent the consensus of task force members.

Judging from experience during the past decade, the recommended system would be dramatically more effective in distinguishing between troubled and sound companies than the current system. As shown in the final pages of this report, half of the improvement in effectiveness results from dropping ineffective tests; the other half results from adding and modifying tests and altering the cutoffs for determining exceptional values.

The recommendations are divided into two groups for phased implementation. For the current year, we recommend that the number of early warning tests be reduced from 26 to 9, including four new tests. For 1975, we recommend that a system based on these nine tests be used to identify priority companies for further analysis and examination.

This report consists of three chapters:

1. Our approach
2. Recommendations for 1974
3. Recommendations for 1975.

1 - OUR APPROACH

As we see it, the basic purpose of the Early Warning System is to identify the companies that may be experiencing financial difficulty. Thus, we suggest that the system should include only those tests which are effective in distinguishing between troubled and sound companies. For companies that may be experiencing difficulties, there is a broad variety of further analyses that should be made and additional ratios that might be calculated in order to determine the source of the difficulty and its degree of severity. The users' manual should provide guidelines for this type of further analysis. However, the inclusion of some of these diagnostic analyses in the basic early warning report would distract the user's attention from the more important ratios intended to help him identify potentially troubled companies. Our interviews with state insurance department personnel indicated that a complex system is much less likely to be understood and used than one that is reasonably simple. Therefore, we suggest that the report include only information that contributes to the basic purpose of identifying companies for which further analysis and examination may be required.

In order to determine the effectiveness of a given ratio in distinguishing between troubled and sound companies, we compared the ratios of a group of companies that became insolvent during the past decade with the ratios of a group of financially sound companies. We believe that this historical, or retrospective, approach provides the most solid, factual basis for judging the effectiveness of a test in discriminating between troubled and sound companies. Since conditions change, it is possible that the discriminating effectiveness of a given test will improve or decline over time. However, we have identified no trends in the life insurance industry that would lead us to conclude that the historical approach to judging the effectiveness of the tests discussed in this report should be set aside.

This chapter of the report describes the samples of insolvent and sound companies used in our analysis and explains the method by which test results for these two groups of companies were compared.

EXHIBIT I

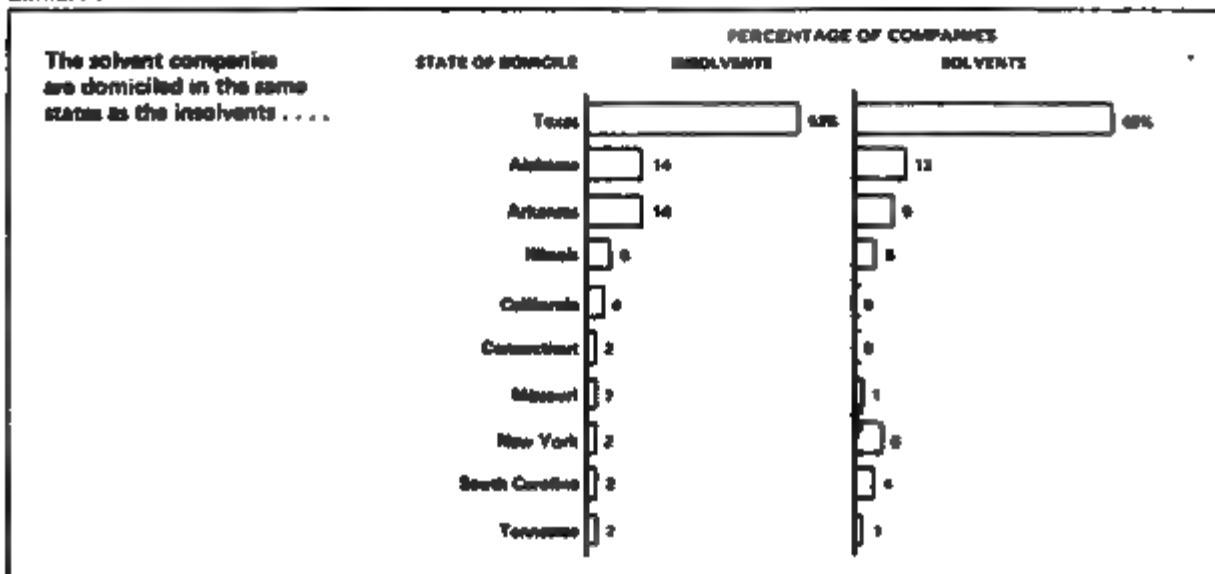


EXHIBIT II

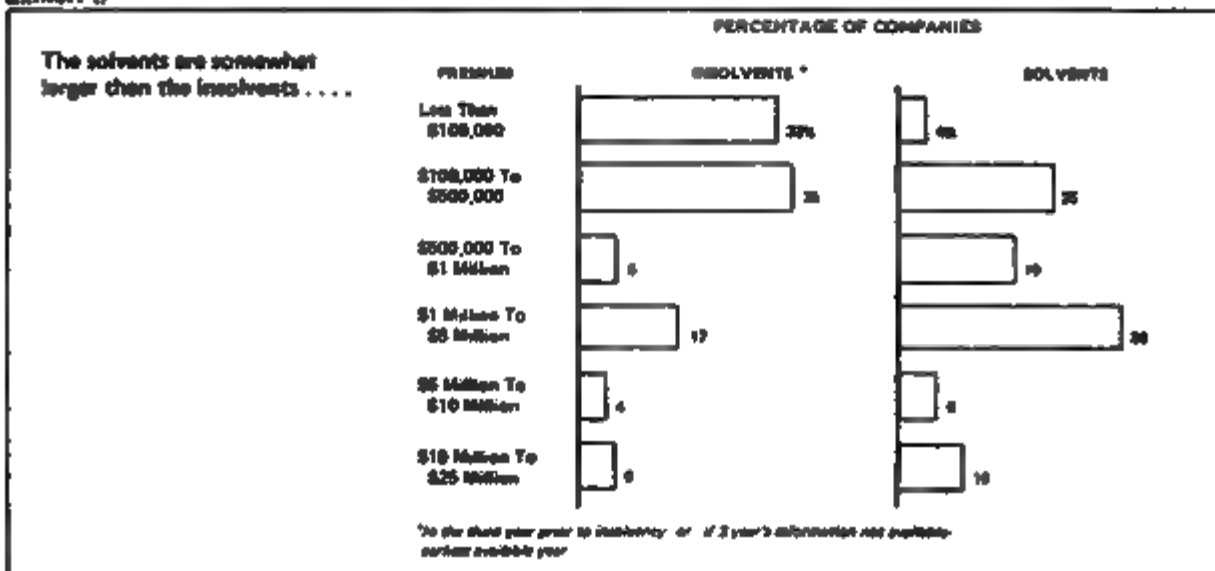
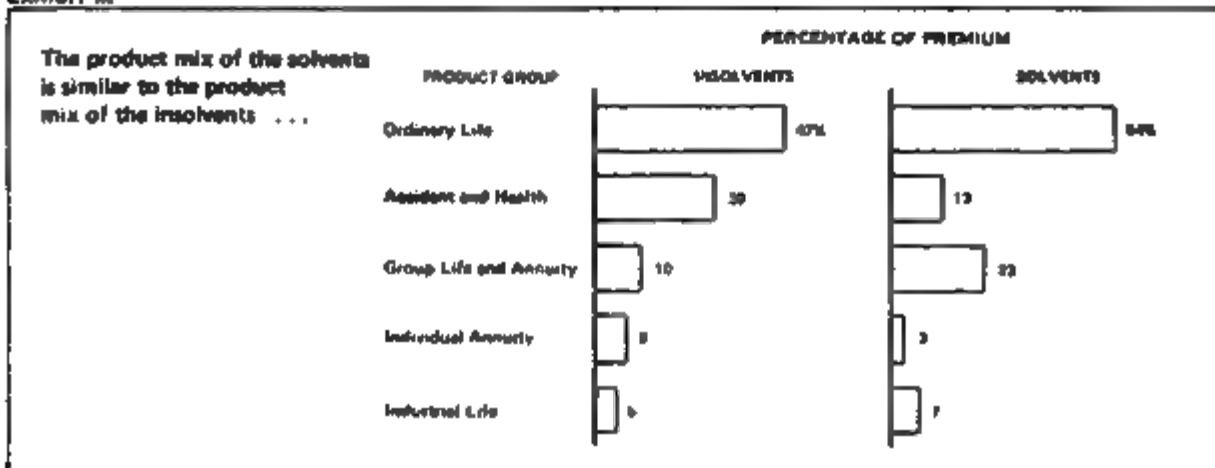


EXHIBIT III



THE SAMPLES

Through the use of questionnaire returns from insurance departments and published sources, we identified 101 life and health companies that were liquidated or came under state control during the past decade. We then requested that the insurance departments of the states in which the "insolvent" companies were domiciled provide copies of annual statement pages 2 through 15 and Schedule H for the five years preceding insolvency. We received annual statements for 50 of the insolvent companies for periods ranging from one to eight years prior to insolvency. Of the 50 companies, annual statements were available for the full five years for 25 companies; for nine companies we received only the final year's statement.

At the same time, we received annual statements for 1971 and 1972 for 85 solvent companies. The solvent company sample was developed by providing the states that had experienced insolvencies with a list of domestic companies of roughly the same size as the insolvents. (This list was drawn at random from Best's Insurance Reports.) We requested each department to remove from the list any company clearly experiencing financial difficulty and to supply annual statements for the remaining companies.

Thus, the solvent company sample was screened to eliminate clearly troubled companies and was approximately matched with the insolvent companies in state of domicile (Exhibit I) and premium volume (Exhibit II). In addition, we found the two groups were also similar in product mix (Exhibit III). Of the insolvent companies, 8 percent were mutuals; 6 percent of the solvent companies were mutuals.

METHOD OF DETERMINING TEST EFFECTIVENESS

The effectiveness of the various tests in discriminating between troubled and sound companies was determined in the following manner: For each test, we selected a series of test values spanning the range of possible values. We then calculated, separately for insolvent and solvent companies, the percentage with results below each of these values. Finally, we plotted these pairs of related percentages graphically. The line formed by the plotted points, such as line A in Exhibit IV on the following page, represents the discriminating effectiveness of the test. The further the line departs from the diagonal line representing equal percentages of insolvents and solvents (line C), the more discriminating the test. Thus, test A in Exhibit IV is more effective than test B, this judgment can be made without regard to any particular cutoff or bench-mark test result.

EXHIBIT IV

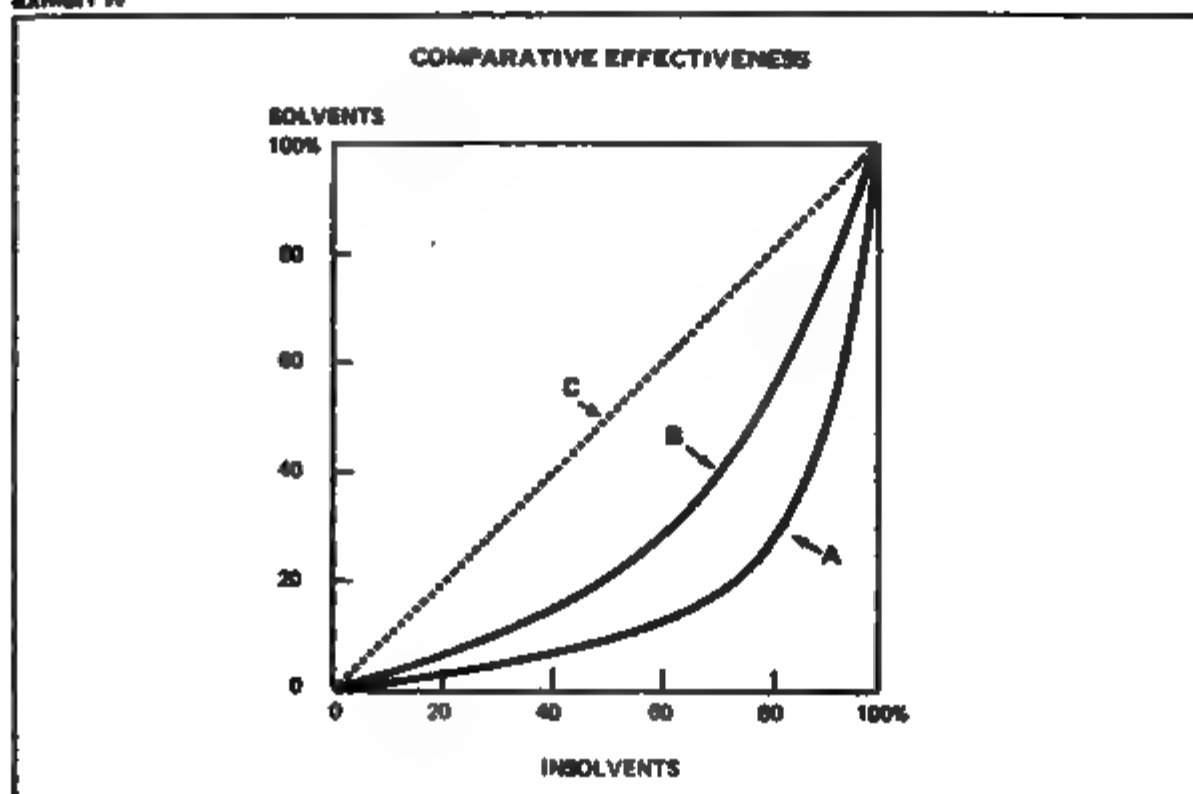
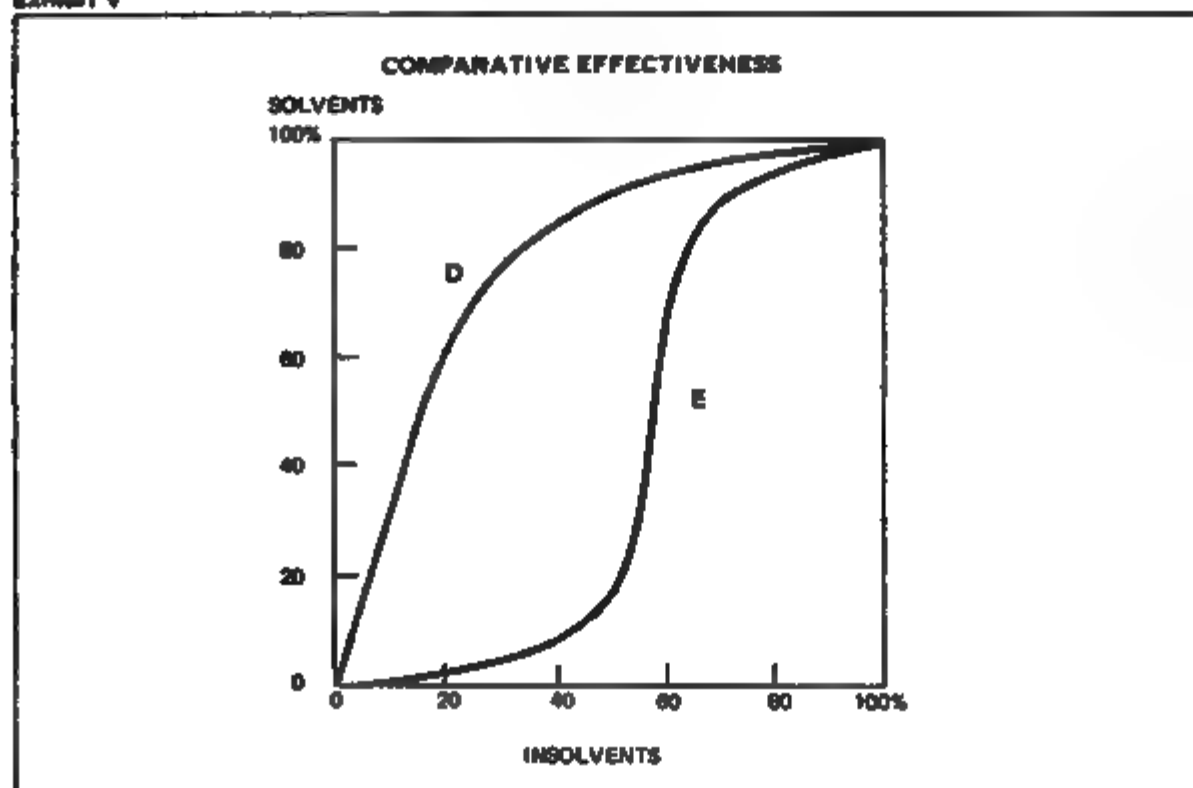


EXHIBIT V



If the line thus plotted for a given test curves downward - as for both tests A and B in Exhibit IV - it is the lower range of test results that distinguishes troubled companies. If the line curves upward - such as line D in Exhibit V - the higher range of test results distinguishes troubled companies. Finally, if the line forms an "S" curve - as line E in Exhibit V - both low and high test results distinguish troubled companies.

EXHIBIT VI

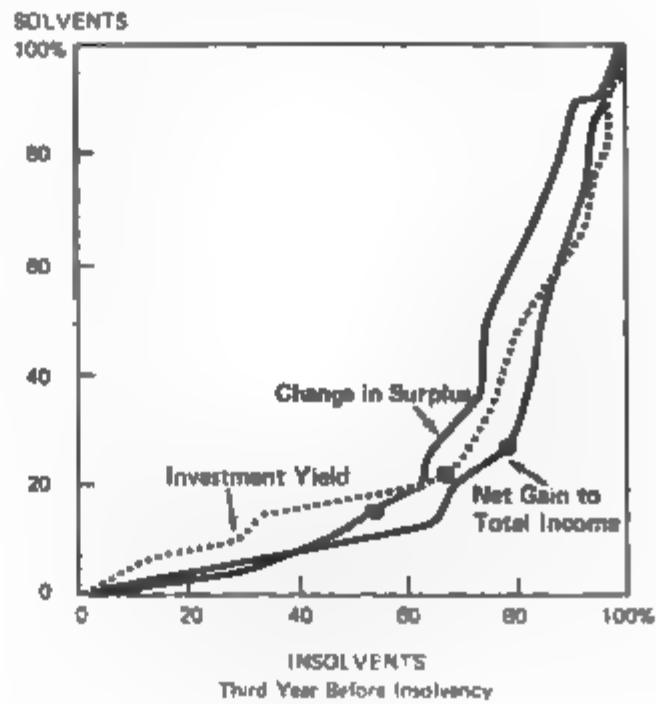
The current system uses "static" and "dynamic" versions of 13 tests

CURRENT TESTS

1. Change in Surplus
2. Net Gain to Total Income
3. Investment Yield
4. Stocks and Collateral Loans to Surplus and MSVR
5. Real Estate to Cash and Invested Assets
6. Investments in Affiliates to Cash and Invested Assets
7. Reinsurance Ceded Reserve and Liability Items to Surplus
8. Individual Life Reserve Increases to Renewal and Single Premium
9. Life Lapse Rate
10. Group Health Reserve Development to Surplus
11. Individual Health Reserve Development to Surplus
12. Commissions, Expenses, Taxes, Licenses, and Fees; and Increases in Agents' Debt Balances to Premium Income
13. Amount of Insurance Issued to Average Amount In-Force

EXHIBIT VII

The first three tests are effective in distinguishing between troubled and sound companies



2 - RECOMMENDATIONS FOR 1974

This chapter presents recommendations on the tests, screening benchmarks and report format for the current year. It is divided into four sections:

1. Current tests
2. New tests
3. Static and dynamic approaches
4. Report format.

We understand that current plans call for 1973 test results to be calculated and distributed during the second half of 1974, and that implementation of the recommended tests for 1974 would be feasible without causing major delays in this schedule.

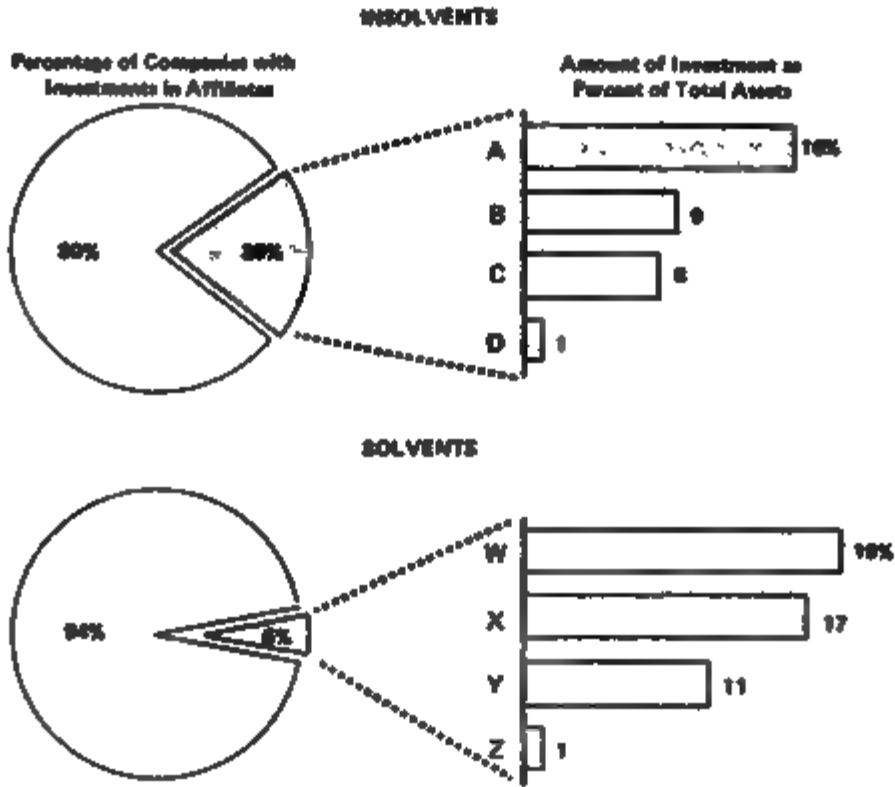
CURRENT TESTS

We will review the effectiveness of the current tests - which are listed in Exhibit VI - in numerical order.

The first three tests - change in surplus, net gain to total income, and investment yield - deal with the company's profitability. As shown in Exhibit VII, these tests are effective in discriminating between troubled and sound companies. On all three tests, insolvent companies are distinguished by low test results. In Exhibit VII, the insolvent companies are taken in the third year prior to insolvency; when the insolvent companies are measured in other years, the results are approximately the same, except that results on the change in surplus test tend to become less favorable for insolvent companies in their final year. The large dots

EXHIBIT VII

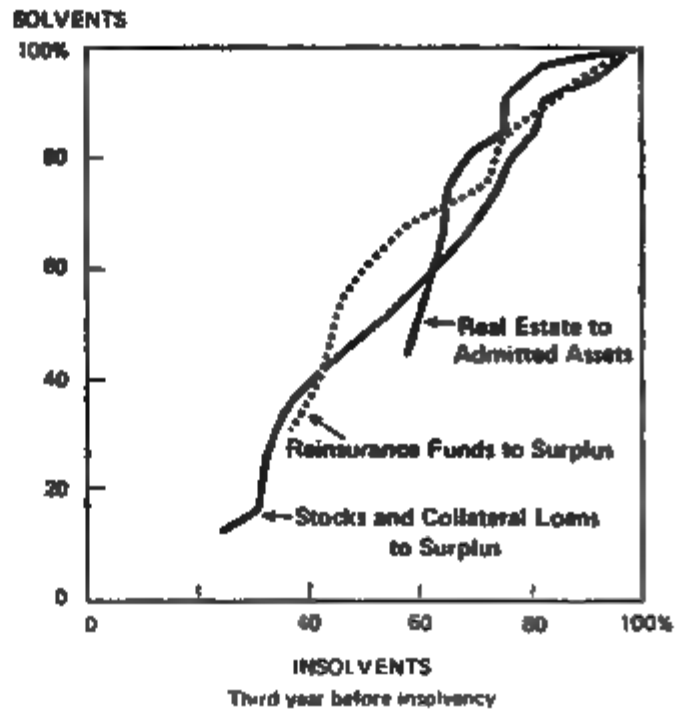
Although a larger percentage of insolvents than solvents has investments in affiliates, those investments are not as large a percentage of total assets



Source: Best's Insurance Reports.

EXHIBIT IX

Three asset tests do not distinguish troubled from sound companies



on the lines in Exhibit VII represent the test results shown in Table 1 below, which we recommend be used in determining exceptional values to help identify companies for high-priority attention.

Table 1

<u>Test</u>	<u>Exceptional Values</u>	<u>Percentage of Companies With Exceptional Values</u>	
		<u>Insolvents*</u>	<u>Solvents</u>
1. Change in Surplus	-10.0% or less	53 to 86%	15%
2. Net Gain	0.0 or less	60 to 72	25
3. Investment Yield	3.5 or less	58 to 78	20

* - Depending upon period of time before insolvency.

The next four tests - stocks and collateral loans, real estate, investments in affiliates, and reinsurance reserve reductions - are tests of assets (in the case of reinsurance, reductions in liabilities). One of these, investments in affiliates, could not be fully evaluated, due to the absence of information in annual statements for most insolvent companies. A review of the comments on the investments of the insolvent and solvent companies in Best's Insurance Reports shows that a higher percentage of the insolvents had investments in affiliates. However, among companies that did show investments in affiliates, the solvent companies tended to have higher test results than the insolvents (Exhibit VIII). Given the absence of complete information and the mixed conclusions that can be drawn from the information that is available, we recommend that the use of this test be deferred until its effectiveness can be adequately evaluated.

The three remaining asset tests - stocks and collateral loans, real estate, and reinsurance reserve reductions - do not distinguish between troubled and sound companies. Exhibit IX shows the lack of effectiveness of these tests when the insolvent companies are taken in the third year prior to insolvency, the conclusion is the same for the other years, as well. This conclusion appears consistent with the belief of many chief examiners (expressed during our interviews and follow-up calls) that few, if any, insolvencies are due to capital losses or the failure of reinsurers.

EXHIBIT X

The change in the reserving ratio is an effective test, with both high and low results distinguishing troubled companies

CHANGE IN THE RATIO OF LIFE RESERVE INCREASES TO
LIFE RENEWAL AND SINGLE PREMIUM

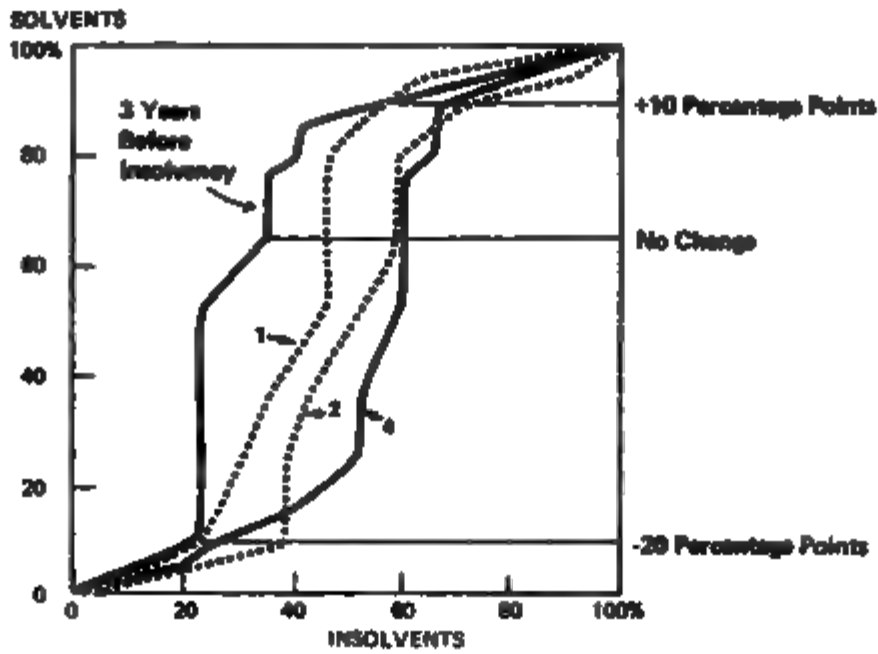
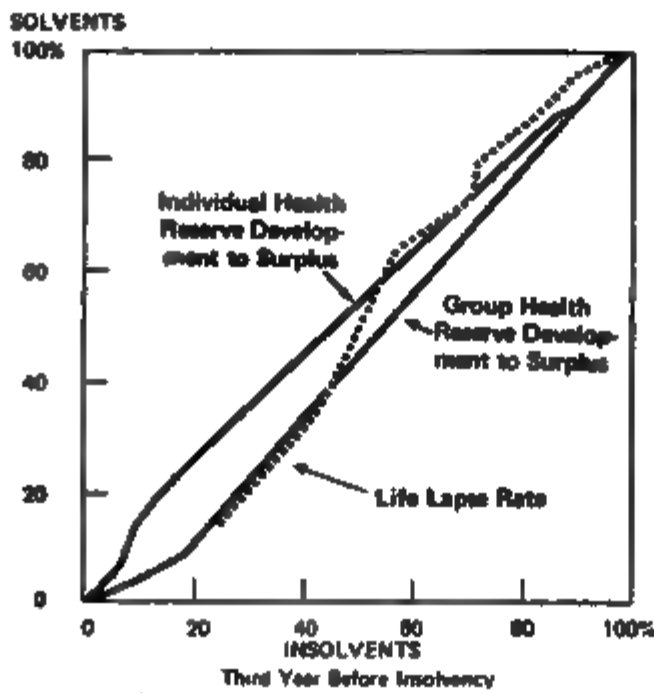


EXHIBIT XI

The life lapse rate and reserve development tests do not distinguish troubled from sound companies



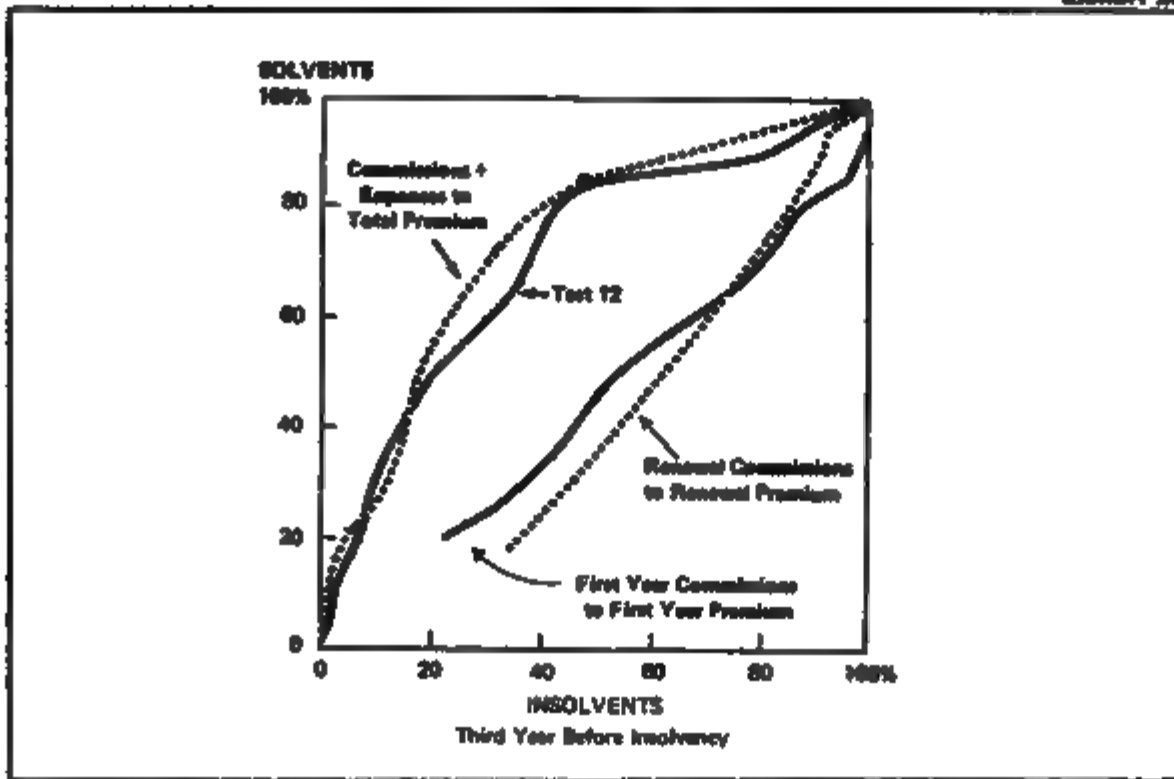
As the task force anticipated, the ratio of individual life reserve increases to renewal and single premium does not discriminate between troubled and sound companies. However, the change in this ratio from one year to the next is a highly effective test. Exhibit X shows the discriminating effectiveness of the change in the reserving ratio. The four lines on the exhibit show insolvents taken in each of the four years prior to insolvency. Using cutoffs of minus 20 percentage points and plus 10 points on this test would have identified approximately 70 percent of the insolvents in each of their last three years and about 60 percent of the insolvents in the fourth year prior to insolvency; these cutoffs would have identified only 20 percent of the companies in the solvent sample. We recommend that the change in the ratio of life reserve increases to renewal and single premium be retained as an early warning test and that exceptional values be those below minus 20 percentage points and above plus 10 points.

The next three tests - life lapse rate, group and individual health reserve development to surplus - are illustrated in Exhibit XI. None of these tests is effective in distinguishing troubled from sound companies, and we recommend that they be dropped.

Test 12 is the ratio of commissions; expenses; taxes, licenses, and fees; and the increase in agents' debit balances to premium. As currently formulated, this test is effective in distinguishing between troubled and sound companies (Exhibit XII). However, a somewhat simplified formula - commissions and expenses to premium - is slightly more effective. More importantly, the simpler test would be easier to understand and use. We recommend this test be retained in the simplified form.

It is interesting to note that the commission element in this test does not contribute to its discriminating effectiveness. As shown in Exhibit XII, the ratios of both new and renewal commissions to premium fail to distinguish between the insolvent and solvent companies. However, the exclusion of commissions from the formula would be prejudicial to companies operating on the branch office plan.

In establishing a cutoff for determining exceptional values on the ratio of commissions and expenses to premium, we explored the possibility of relating the cutoff to the company's rate of growth. However, an analysis of the test results of the two samples of companies showed no clear relationship between this test and premium growth (Exhibit XIII). We thus concluded that a uniform cutoff should be used in determining exceptional values, regardless of a company's growth rate. Further analysis suggested that 60 percent would be the best cutoff. This value is indicated by the dot on the



There is no clear relationship between expense level and premium growth

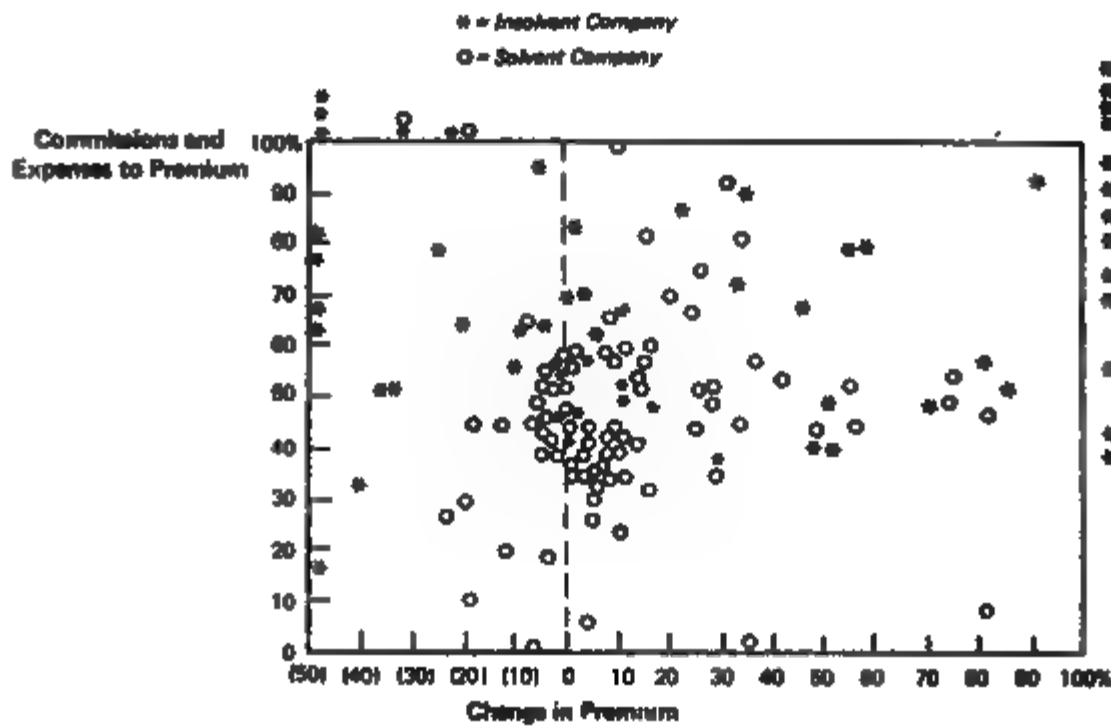


EXHIBIT XIV

New business to in-force is a less effective test than change in premium, on which both high and low results distinguish troubled companies

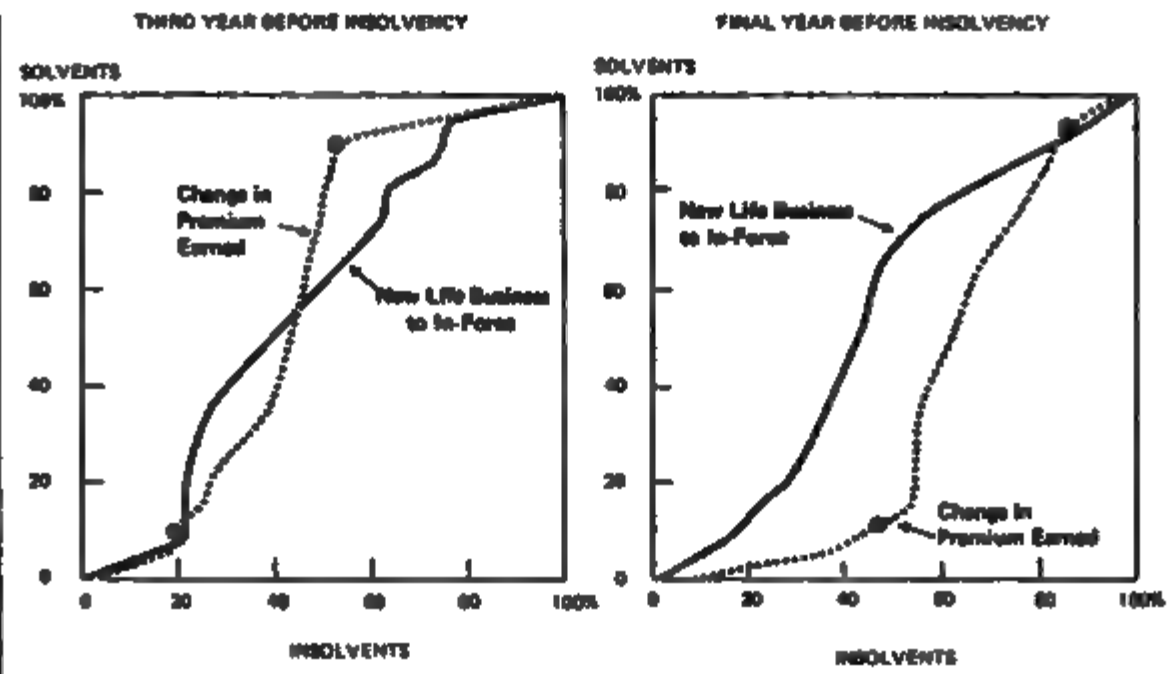
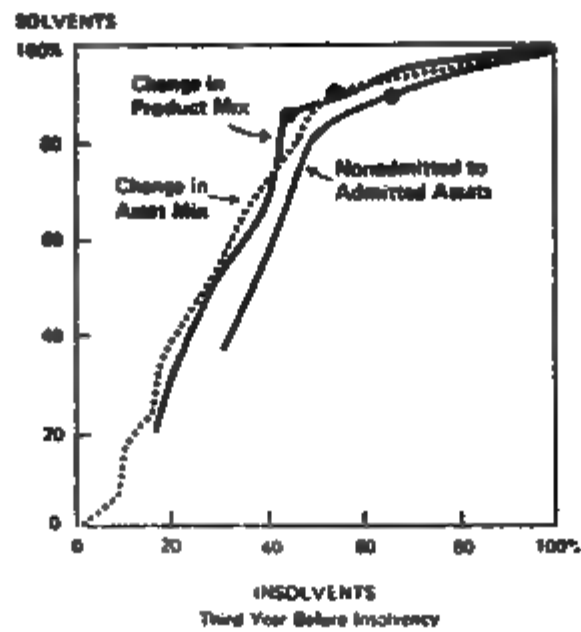


EXHIBIT XV

The change in product mix and asset mix and the ratio of nonadmitted to admitted assets are effective tests



line for the ratio of commissions and expenses to premiums in Exhibit XII. Use of this cutoff would have identified between 52 and 61 percent of the insolvent companies (depending upon the year chosen); it would have identified only 15 percent of the solvent company sample.

The final test, new business to in-force, shows only a very modest ability to distinguish between troubled and sound companies. However, an alternative "growth" test - change in premium - proved much more effective. The two tests are compared in Exhibit XIV. In reviewing annual statements, we found that many companies, particularly the insolvents, had difficulty completing annual statement page 15, from which the new business and in-force figures are taken. This may be one cause of the lack of effectiveness of that test.

We recommend that the change in premium test be substituted for the ratio of new business to in-force. Cutoffs for determining exceptional values on the change in premium test should be established at minus 10 and plus 50 percent. These cutoffs (indicated by the dots in Exhibit XIV) would have identified between 65 and 75 percent of the insolvent companies (depending on the year) and 20 percent of the solvent company sample.

NEW TESTS

In addition to the change in premium test discussed above, three new tests were found to discriminate between troubled and sound companies: change in product mix, change in asset mix, and the ratio of nonadmitted to admitted assets. The effectiveness of these tests is illustrated in Exhibit XV.

Results on the change in product mix test represent the change in the percentage of total premium for the average product line. To calculate this test result, the percentage of premium from each product line is determined for the current and prior years. (The product lines are equal to the columns in the gain and loss exhibit on page 5 of the annual statement, with ADD and TPD included in ordinary life.) Next, the difference in the percentage of premium between the two years is determined for each product line. Finally, the total of these differences - without regard to sign - is divided by the number of product lines, to determine the change in the percentage of premium for the average product line.

Due to the addition of two columns for credit life on page 5 of the annual statement for 1973, it will not be possible to calculate the change in product mix test for that year. Further analysis of the methods discussed in Chicago for approximating this test result for 1973 shows them to be inadequate.

EXHIBIT XVI

SUMMARY OF RECOMMENDED TESTS FOR 1974

	EXCEPTIONAL VALUES	
	LESS THAN OR EQUAL TO	GREATER THAN OR EQUAL TO
Financial Tests		
1. Change in Surplus	-10.0%	
2. Net Gain to Total Income	0.0	
3. Commissions and Expenses to Premium		60.0
4. Investment Yield	3.5	
5. Nonadmitted to Admitted Assets		10.0
Stability Tests		
6. Change in Premium	-10.0	60.0
7. Change in Product Mix		3.0
8. Change in Asset Mix		6.0
9. Change in Ratio of Individual Life Reserve Increases to Renewal and Single Premium	-20.0	10.0

Therefore, we recommend that calculation of the change in product mix be omitted for 1973, but included for prior (and subsequent) years.

The change in asset mix test is calculated in a similar manner, using the percentage of cash and invested assets in each of the 10 categories of assets that comprise total cash and invested assets.

The recommended cutoffs for determining exceptional values on these three new tests (shown as dots on Exhibit XV) are given in Table 2 below.

Table 2

<u>Test</u>	<u>Exceptional Values</u>	<u>Percentage of Companies With Exceptional Values</u>	
		<u>Insolvents</u> [*]	<u>Solvents</u>
Nonadmitted Assets	10.0% or more	26 to 43%	9%
Change in Product Mix	3.0 or more**	34 to 58	12
Change in Asset Mix	5.0 or more	24 to 47	10

* - Depending upon period of time prior to insolvency.

** - For 1974 and subsequent years, this cutoff should be adjusted to 5.0%, to reflect the increase in the number of product lines from seven to nine.

The nine recommended tests - old and new - are summarized on Exhibit XVI, together with the recommended cutoffs for determining exceptional values. Appendix A contains more precise definitions of these tests.

At the task force meeting in Chicago on March 18, we also discussed the possible use of adjusted earnings and adjusted balance sheet tests in the Early Warning System. Although we have decided not to recommend that approach, Appendix B to this report discusses these adjusted tests and our reasons for not recommending their adoption.

STATIC AND DYNAMIC APPROACHES

Four of the nine recommended tests are inherently "dynamic" in nature - change in surplus, change in premium, change in product mix, and change in asset mix. There are no "static" equivalents of these tests.

EXHIBIT XVI

LIFE AND HEALTH EARLY WARNING 1973 RESULTS			FINANCIAL TESTS					STABILITY TESTS				Premiums (\$ millions)
Release 1, Page 1 July 20, 1974			Change in Surplus	Net Gain to Total Income	Change & Exp. in Premiums	Investment Yield	Nonadmitted to Assets	Change in Premiums	Change in Product Mix	Change in Asset Mix	Change in Reserving	
Exceptional Values	{	Over: Under:	-10	0	60	3.5	10	50	3.0	5.0	10	
							-10				-20	
ABC Life Insurance New York	73	7	5	33	5.2	0	10	NA	0.4	1		1 172.6
	72	9	6	32	5.1	0	19	0.0	0.5	2		1 071.3
	71	8	4	33	5.0	0	11	0.1	0.4	3		902.7
XYZ Mutual Life Connecticut	73	-10*	5	51	2.7*	16*	55*	NA	3.7	1		4.7
	72	-2	-1*	55	2.8*	15*	72*	0.8	2.3	4		3.1
	71	-6	1	53	2.7*	14*	38	0.6	2.7	3		1.7

* Exceptional values (results equal to cutoff are considered exceptional values).

The fifth dynamic test (change in the reserving ratio) is derived from a static ratio between reserve increases and renewal and single premium. The dynamic test result is equal to the change in this static ratio between the two years. Therefore, it would be possible to report the static ratios as well as the dynamic test result. We recommend, however, that these static ratios not be included in the early warning report, for two reasons. First, the static ratio does not have, and was never expected to have, the ability to distinguish between troubled and sound companies. We feel that inclusion of this ratio in the report would be likely either to mislead the user into thinking the ratio itself is significant or to confuse him as to the purpose of the report. Second, the user does not need the static ratio in order to understand and interpret results on the dynamic test. If, for example, the dynamic test result is plus 12 percentage points, the user knows that increases in reserves in the current year were greater than the amount they would have been if the reserving ratio had not changed by 12 percent of renewal and single premium. He can even calculate this amount and determine the impact on the company's net gain of the change in the reserving ratio. Thus, the user need not know the ratio of reserve increases to premium in order to understand and interpret results on the test of the change in the reserving ratio.

Four of the recommended tests are static in nature: net gain to total income, investment yield, commissions and expenses to premium, and non-admitted to admitted assets. For these tests, we recommend that the changes in the ratios from one year to the next not be printed in the early warning report. Printing the changes would not provide any additional information - the changes can easily be calculated from the test results themselves. More importantly, the dynamic versions of these tests are significantly less helpful in identifying troubled companies than the tests themselves. Printing the dynamic versions of these tests would be likely to distract the user's attention from the more helpful test results, whereas omitting them would not deprive him of any information.

REPORT FORMAT

A suggested format for reporting test results during 1974 is illustrated in Exhibit XVII. Key features include:

- § Printing all results for each company on three lines, one for each year
- § Showing test names and cutoffs for exceptional values
- § Identifying exceptional values with an asterisk
- § Rounding results to nearest whole percent except for the investment yield, change in product mix, and change in asset mix tests
- § Showing state of domicile and premium.

EXHIBIT XXII

Eleven insolvents would not have been priority companies in one or more of their last four years

WOULD THE COMPANY HAVE BEEN A PRIORITY COMPANY?

COMPANY AND STATE	YEARS BEFORE INSOLVENCY			
	4	3	2	1
Century Life (Tex.)	-	-	NO	NO
Alabama National (Ala.)	-	-	NO	YES
New South Life (S.C.)	NO	NO	YES	YES
Midwestern Investors (Tex.)	NO	YES	YES	YES
Universal Security (Tex.)	NO	YES	YES	YES
Mutual Opportunity (Tex.)	YES	NO	NO	NO
Equity Funding (Ill.)	YES	YES	NO	NO
National Bankers (Tex.)	YES	NO	NO	YES
Inter American (Tex.)	YES	NO	YES	YES
Family Savings (Tex.)	YES	YES	YES	NO
Texas General (Tex.)	YES	YES	YES	NO

EXHIBIT XIX

The recommended priority system would have identified about 88 percent of the insolvents in each of their last 4 years and only 17 percent of the solvent company sample

PERCENTAGE OF COMPANIES GIVEN PRIORITY CLASSIFICATION

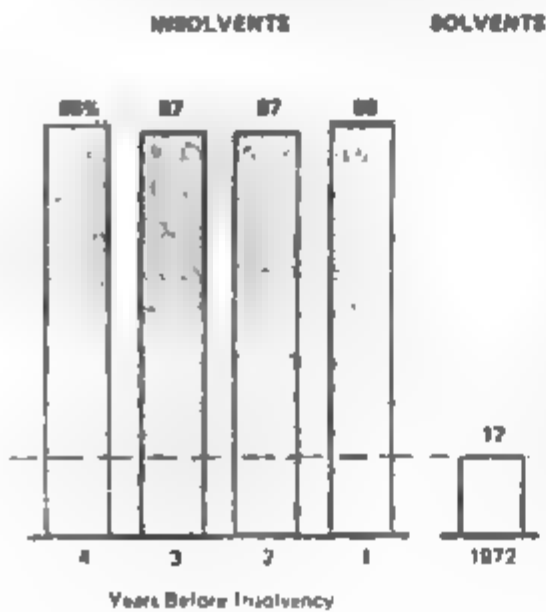
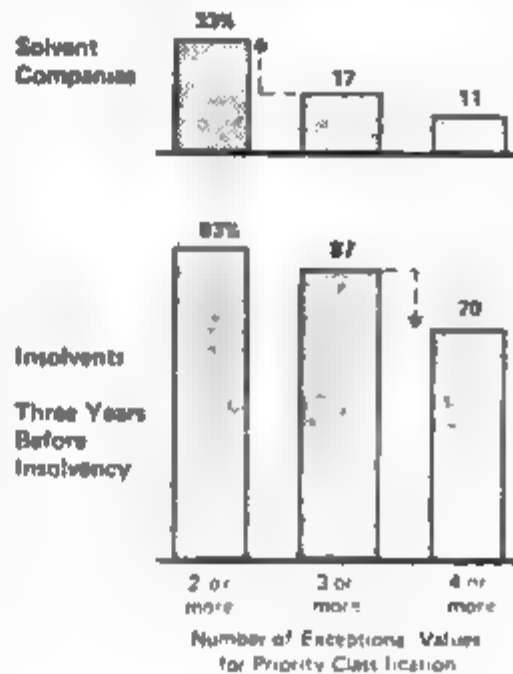


EXHIBIT XX

The "three or more exceptional values" screening rule provides the best balance between solvent and insolvent companies identified

PERCENTAGE OF COMPANIES GIVEN PRIORITY CLASSIFICATION



3 - RECOMMENDATIONS FOR 1975

In order to be most useful, the Early Warning System should clearly indicate which companies are most likely to require in-depth analysis and on-site examination. Simply providing the results for each company on the nine tests leaves the user uncertain as to how these results should be interpreted together and how an overall opinion on a company's condition should be formed. Our interviews and questionnaire responses indicate that this problem has in many states been an obstacle to achieving the maximum benefit from the Property and Liability Early Warning System during the past two years. Therefore, we have developed a method by which each life company's results on the nine recommended tests can be used to place that company in either a priority or a nonpriority group. Priority companies would be those most likely to require further analysis and examination.

RECOMMENDED SYSTEM

We recommend that, beginning with test results calculated in 1975, the priority designation be given to companies with exceptional values on three or more of the nine recommended tests. Under this system, all but one of the insolvent companies studied would have been given the priority designation at some time during their last four years. The single exception was Century Life, of Texas, for which test results were available for only the last two years. Ten other insolvent companies would not have received the priority designation in one or more of their last four years; Exhibit XVIII indicates the years in which these companies would and would not have been priority companies. All of the remaining insolvents would have been priority companies in all years for which test results could be calculated. About 88 percent of the insolvent companies would have been priority companies in each of the four years prior to insolvency, 17 percent of the solvent company sample would be priority companies (Exhibit XIX).

Exhibit XX compares this "three-of-nine tests" rule with two- and four-test rules. If all companies with exceptional values on two or more tests received the priority designation, the percentage of solvents so classified would almost double. If only those companies with exceptional values on four or more tests were priority companies, the percentage of insolvents

EXHIBIT XXII

The recommended system is significantly more effective than the current system

PERCENTAGE OF COMPANIES
GIVEN PRIORITY CLASSIFICATION

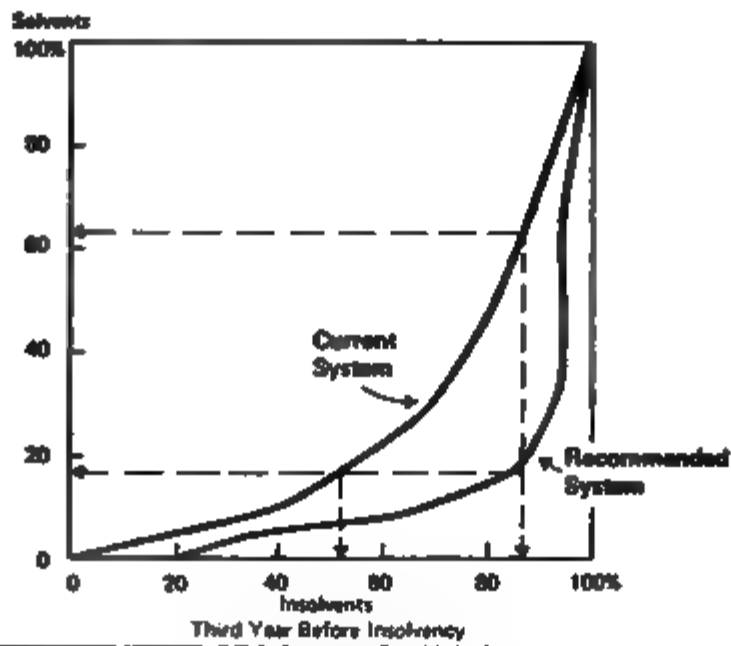
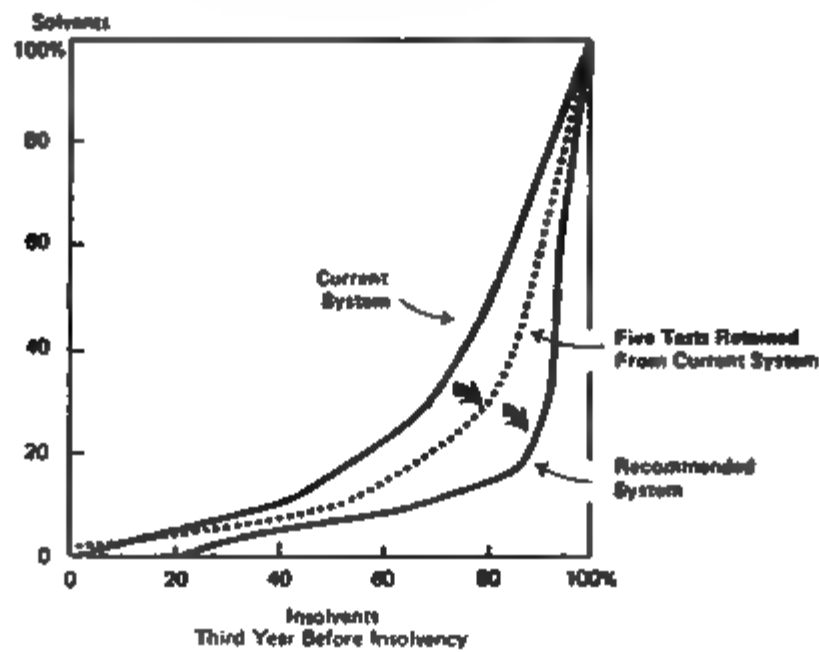


EXHIBIT XXIII

Half the improvement in effectiveness comes from dropping the ineffective tests

PERCENTAGE OF COMPANIES
GIVEN PRIORITY CLASSIFICATION



correctly identified would drop as low as 70 percent in the second year prior to insolvency.

Before the recommended priority company system is implemented, we suggest the task force determine exactly how many - and which - companies would have received the priority designation in 1974. Because our solvent company sample was screened on several criteria, it is not possible to conclude that the percentage of all companies that would be identified would be equal to the 17 percent of the solvent sample. However, we expect that the percentage of all companies identified should be less than 20 percent. Calculation of the results on the nine recommended tests during 1974 will permit the task force to determine whether this estimate is accurate and will also allow the companies that would have been classified as priority companies this year to be identified.

If this analysis reveals that a significantly larger percentage of companies than expected (say, 25 percent or more) would be classified as priority companies, the task force should fine-tune the screening system to reduce priority companies to a manageable number. This fine-tuning could be accomplished by: (1) raising the number of exceptional values required for priority identification, or (2) altering the cutoffs for establishing exceptional values. Of course, the best approach would be that which reduces the percentage of all companies identified to a manageable number while maintaining the highest possible percentage of insolvents identified. To assist the task force in this analysis, should it prove necessary, we will provide a tabulation of the test results for the insolvent companies in our sample.

COMPARISON WITH CURRENT SYSTEM

The discriminating effectiveness of a group of tests can be measured by a graph similar to the graphs used to measure the effectiveness of individual tests. Such a graph would be based on the number of exceptional values out of the group of tests, rather than on the test result on a single test.

Exhibit XXI uses such a graph to compare the recommended system with the current system of 26 tests with cutoffs for determining exceptional values established at the tenth percentile of solvent company results. In order to identify as many of the insolvents in the third year prior to insolvency as the recommended system (87 percent), the screening criterion under the current tests and bench marks would have to be set at two or more exceptional values; this would also throw about 60 percent of the solvent sample into the priority group, compared with only 17 percent for the

recommended system. On the other hand, if the screening criterion were set at five or more exceptional values out of 26 tests, the current tests and bench marks would identify approximately the same percentage of solvent companies as the recommended system, but the percentage of insolvents correctly identified three years before insolvency would drop from 87 to 52 percent.

In Exhibit XXII, the solid lines are the same as the lines for the current and recommended systems in Exhibit XXI. The dotted line represents the effectiveness of the five tests retained from the current system, with exceptional values being those in the extreme 10 percent of solvent company results. It is interesting to note that about half of the improvement in effectiveness from the recommended system - as measured by the distance from the line representing the current system to the dotted line in Exhibit XXII - is due simply to dropping the ineffective tests. The rest of the improvement - the distance from the dotted line to the line for the recommended system - is due to adding and modifying tests and adjusting the cutoffs for determining exceptional values.

SPECIFICATIONS FOR RECOMMENDED TESTSINDEX

	<u>Page</u>
Test 1: Change in Surplus	A - 2
Test 2: Net Gain to Total Income	A - 3
Test 3: Commissions and Expenses to Premium	A - 4
Test 4: Investment Yield	A - 5
Test 5: Nonadmitted to Admitted Assets	A - 6
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Test 7: Change in Product Mix	
1972 and Prior Years	A - 8
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Test 8: Change in Asset Mix	A - 15
Test 9: Change in Reserving Ratio	
1972 and Prior Years	A - 19
1973	A - 21
1974 and Subsequent Years	A - 23

TEST 1: CHANGE IN SURPLUS

All years

Current year: page 3, line 30
 - Current year: page 4, line 39
 - Prior year: page 3, line 30
 = A

A
 + Prior year: page 3, line 30
 = B

B
 x 100
 = Result (round to nearest integer)

If page 3, line 30 is zero or negative for either the current or the prior year, test result is -99.

A - 2

TEST 2: NET GAIN TO TOTAL INCOME

All years

Current year: page 5, col. 1, line 33
+ Current year: page 5, col. 1, line 7
= A

A
× 100
= Result (round to nearest integer)

If page 5, col. 1, line 7 is zero or negative, no test result is calculated.

A - 3

TEST 3: COMMISSIONS AND EXPENSES TO PREMIUM**All years**

Current year: page 5, col. 1, line 21
 + Current year: page 5, col. 1, line 23
 = A

A
 + Current year: page 5, col. 1, line 1
 = B

B
 × 100
 = Result (round to nearest integer)

If page 5, col. 1, line 1 is zero or negative, no test result is calculated.

A - 4

TEST 4: INVESTMENT YIELD**All years****Current Year Statement**

Page 2, line 10A*
 + Page 2, line 19
 - Page 3, line 23
 = A

Prior Year Statement

Page 2, line 10A*
 + Page 2, line 19
 - Page 3, line 23
 = B

A
 + B
 - Current year: page 5, col. 1, line 4
 = C

C
 + 2
 = D

Current year: page 5, col. 1, line 4
 + D
 = E

E
 × 100
 = Result (round to nearest tenth)

If D is zero or negative, no test result is calculated.

* - If page 2, line 10A is not completed, this amount is equal to the of lines 1 through 10 on page 2.

TEST 5: NONADMITTED TO ADMITTED ASSETS

All years

Current year: page 14, col. 3, line 26
 + Current year: page 14, col. 4, line 26
 = A

A
 x 100
 = Result (round to nearest integer)

If page 14, col. 4, line 26 is zero or negative and page 14, col. 3, line 26 is positive, test result is 999.

A - 6

TEST 6: CHANGE IN PREMIUM**All years**

Current year: page 5, col. 1, line 1
 - Prior year: page 5, col. 1, line 1
 = A

A
 + Prior year: page 5, col. 1, line 1
 = B

B
 × 100
 = Result (round to nearest integer)

If both current and prior year page 5, col. 1, line 1 are zero or negative, test result is zero. If prior year page 5, col. 1, line 1 is zero or negative but current year page 5, col. 1, line 1 is positive, test result is 999.

A - 7

TEST 7: CHANGE IN PRODUCT MIX

1972 and prior years

Current year: page 5, col. 2, line 1
 ÷ Current year: page 5, col. 1, line 1
 = A

Prior year: page 5, col. 2, line 1
 ÷ Prior year: page 5, col. 1, line 1
 = B

A
 - B
 = C (If C is negative, multiply C by -1)

Current year: page 5, col. 3, line 1
 + Current year: page 5, col. 4, line 1
 + Current year: page 5, col. 5, line 1
 = D
 ÷ Current year: page 5, col. 1, line 1
 = E

Prior year: page 5, col. 3, line 1
 + Prior year: page 5, col. 4, line 1
 + Prior year: page 5, col. 5, line 1
 = F
 ÷ Prior year: page 5, col. 1, line 1
 = G

E
 - G
 = H (If H is negative, multiply H by -1)

Current year: page 5, col. 6, line 1
 ÷ Current year: page 5, col. 1, line 1
 = I

Prior year: page 5, col. 6, line 1
 ÷ Prior year: page 5, col. 1, line 1
 = J

A - 8

I
 - J
 = K (If K is negative, multiply K by -1)

Current year: page 5, col. 8, line 1
 + Current year: page 5, col. 1, line 1
 = L

Prior year: page 5, col. 8, line 1
 + Prior year: page 5, col. 1, line 1
 = M

L
 - M
 = N (If N is negative, multiply N by -1)

Current year: page 5, col. 9, line 1
 + Current year: page 5, col. 1, line 1
 = O

Prior year: page 5, col. 9, line 1
 + Prior year: page 5, col. 1, line 1
 = P

O
 - P
 = Q (If Q is negative, multiply Q by -1)

Current year: page 5, col. 10, line 1
 + Current year: page 5, col. 1, line 1
 = R

• Prior year: page 5, col. 10, line 1
 + Prior year: page 5, col. 1, line 1
 = S

R
 - S
 = T (If T is negative, multiply T by -1)

Current year: page 5, col. 11, line 1
 + Current year: page 5, col. 1, line 1
 = U

Prior year: page 5, col. 11, line 1
 + Prior year: page 5, col. 1, line 1
 = V

U
 - V
 = W (If W is negative, multiply W by -1)

C
 + H
 + K
 + N
 + Q
 + T
 + W
 = X

X
 + 7
 = Y

Y
 x 100
 = Result (round to nearest tenth)

If page 5, col. 1, line 1 is zero or negative for either the current or the prior year, no test result is calculated.

A - 10

TEST 7: CHANGE IN PRODUCT MDX

1974 and subsequent years

Current year: page 5, col. 2, line 1
 + Current year: page 5, col. 1, line 1
 = A

Prior year: page 5, col. 2, line 1
 + Prior year: page 5, col. 1, line 1
 = B

A
 - B
 = C (If C is negative, multiply C by -1)

Current year: page 5, col. 3, line 1
 + Current year: page 5, col. 1, line 1
 = D

Prior year: page 5, col. 3, line 1
 + Prior year: page 5, col. 1, line 1
 = E

D
 - E
 = F (If F is negative, multiply F by -1)

Current year: page 5, col. 4, line 1
 + Current year: page 5, col. 1, line 1
 = G

Prior year: page 5, col. 4, line 1
 + Prior year: page 5, col. 1, line 1
 = H

G
 - H
 = I (If I is negative, multiply I by -1)

Current year: page 5, col. 5, line 1
 + Current year: page 5, col. 1, line 1
 = J

Prior year: page 5, col. 5, line 1
 + Prior year: page 5, col. 1, line 1
 = K

J
 - K
 = L (If L is negative, multiply L by -1)

Current year: page 5, col. 6, line 1
 + Current year: page 5, col. 1, line 1
 = M

Prior year: page 5, col. 6, line 1
 + Prior year: page 5, col. 1, line 1
 = N

M
 - N
 = O (If O is negative, multiply O by -1)

Current year: page 5, col. 7, line 1
 + Current year: page 5, col. 1, line 1
 = P

Prior year: page 5, col. 7, line 1
 + Prior year: page 5, col. 1, line 1
 = Q

P
 - Q
 = R (If R is negative, multiply R by -1)

Current year: page 5, col. 8, line 1
 + Current year: page 5, col. 1, line 1
 = S

A - 12

Prior year: page 5, col. 8, line 1
 + Prior year: page 5, col. 1, line 1
 = T

S
 - T
 = U (If U is negative, multiply U by -1)

Current year: page 5, col. 9, line 1
 + Current year: page 5, col. 1, line 1
 = V

Prior year: page 5, col. 9, line 1
 + Prior year: page 5, col. 1, line 1
 = W

V
 - W
 = X (If X is negative, multiply X by -1)

Current year: page 5, col. 10, line 1
 + Current year: page 5, col. 1, line 1
 = Y

Prior year: page 5, col. 10, line 1
 + Prior year: page 5, col. 1, line 1
 = Z

Y
 - Z
 = AA (If AA is negative, multiply AA by -1)

Current year: page 5, col. 11, line 1
 + Current year: page 5, col. 1, line 1
 = BB

Prior year: page 5, col. 11, line 1
 + Prior year: page 5, col. 1, line 1
 = CC

BB
 - CC
 = DD (If DD is negative, multiply DD by -1)

C
 + F
 + I
 + L
 + O
 + R
 + U
 + X
 + AA
 + DD
 = EE

EE
 ÷ 9
 = FF

FF
 × 100
 = Result (round to nearest tenth)

If page 5, col. 1, line 1 is zero or negative for either the current or the prior year, no test result is calculated.

TEST 8: CHANGE IN ASSET MIX**All years**

Current year: page 2, line 1
 + Current year: page 2, line 10A
 = A

Prior year: page 2, line 1
 + Prior year: page 2, line 10A
 = B

A
 - B
 = C (If C is negative, multiply C by -1)

Current year: page 2, line 2 (total)
 + Current year: page 2, line 10A
 = D

Prior year: page 2, line 2 (total)
 + Prior year: page 2, line 10A
 = E

D
 - E
 = F (If F is negative, multiply F by -1)

Current year: page 2, line 3
 + Current year: page 2, line 10A
 = G

Prior year: page 2, line 3
 + Prior year: page 2, line 10A
 = H

G
 - H
 = I (If I is negative, multiply I by -1)

Current year: page 2, line 4 (total)
 + Current year: page 2, line 10A
 = J

A - 15

Prior year: page 2, line 4 (total)
 + Prior year: page 2, line 10A
 = K

J
 - K
 = L (If L is negative, multiply L by -1)

Current year: page 2, line 5
 + Current year: page 2, line 10A
 = M

Prior year: page 2, line 5
 + Prior year: page 2, line 10A
 = N

M
 - N
 = O (If O is negative, multiply O by -1)

Current year: page 2, line 6
 + Current year: page 2, line 10A
 = P

Prior year: page 2, line 6
 + Prior year: page 2, line 10A
 = Q

P
 - Q
 = R (If R is negative, multiply R by -1)

Current year: page 2, line 7
 + Current year: page 2, line 10A
 = S

Prior year: page 2, line 7
 + Prior year: page 2, line 10A
 = T

S
 - T
 = U (If U is negative, multiply U by -1)

Current year: page 2, line 8
 + Current year: page 2, line 10A
 = V

Prior year: page 2, line 8
 + Prior year: page 2, line 10A
 = W

V
 - W
 = X (If X is negative, multiply X by -1)

Current year: page 2, line 9
 + Current year: page 2, line 10A
 = Y

Prior year: page 2, line 9
 + Prior year: page 2, line 10A
 = Z

Y
 - Z
 = AA (If AA is negative, multiply by -1)

Current year: page 2, line 10
 + Current year: page 2, line 10A
 = BB

Prior year: page 2, line 10
 + Prior year: page 2, line 10A
 = CC

BB
 - CC
 = DD (If DD is negative, multiply DD by -1)

C
 + F
 + I
 + L
 + O
 + R
 + U
 + X
 + AA
 + DD
 = EE

EE
 + 10
 = FF

FF
 × 100
 = Result (round to nearest tenth)

If page 2, line 10A is zero or negative for either the current or the prior year, no test result is calculated.

TEST 9: CHANGE IN RESERVING RATIO

1972 and prior years

Current Year Statement

Page 5, col. 2, line 17
 + Page 5, col. 3, line 17
 + Page 5, col. 4, line 17
 + Page 5, col. 5, line 17
 = A

Page 7, col. 2, line 10
 + Page 7, col. 2, line 19
 + Page 7, col. 3, line 10
 + Page 7, col. 3, line 19
 + Page 7, col. 4, line 10
 + Page 7, col. 4, line 19
 + Page 7, col. 5, line 10
 + Page 7, col. 5, line 19
 = B

A
 + B
 = C

If A and B are both zero or negative, let C equal zero. If A is positive and B is zero or negative, let C equal 1.0.

Prior Year Statement

Page 5, col. 2, line 17
 + Page 5, col. 3, line 17
 + Page 5, col. 4, line 17
 + Page 5, col. 5, line 17
 = D

A - 19

Page 7, col. 2, line 10
 + Page 7, col. 2, line 19
 + Page 7, col. 3, line 10
 + Page 7, col. 3, line 19
 + Page 7, col. 4, line 10
 + Page 7, col. 4, line 19
 + Page 7, col. 5, line 10
 + Page 7, col. 5, line 19
 = E

D
 + E
 = F

If D and E are both zero or negative, let F equal zero. If D is positive and E is zero or negative, let F equal 1.0.

C
 - F
 = G

G
 × 100
 = Result (round to nearest integer)

A - 20

TEST 9: CHANGE IN RESERVING RATIO

1974 and subsequent years

Current Year Statement

Page 5, col. 2, line 17
 + Page 5, col. 3, line 17
 = A

Page 7, col. 2, line 10
 + Page 7, col. 2, line 19
 + Page 7, col. 3, line 10
 + Page 7, col. 3, line 19
 = B

A
 ÷ B
 = C

If A and B are both zero or negative, let C equal zero. If A is positive but B is zero or negative, let C equal 1.0.

Prior Year Statement

Page 5, col. 2, line 17
 + Page 5, col. 3, line 17
 = D

Page 7, col. 2, line 10
 + Page 7, col. 2, line 19
 + Page 7, col. 3, line 10
 + Page 7, col. 3, line 19
 = E

D
 ÷ E
 = F

If D and E are both zero or negative, let F equal zero. If D is positive but E is zero or negative, let F equal 1.0.

C
 - F
 = G

G
 × 100
 = Result (round to nearest integer)

A - 23

ADJUSTED EARNINGS AND**BALANCE SHEET TESTS**

Some of the tests that we evaluated for possible inclusion in the Early Warning System employed the concept of adjusted earnings and adjusted balance sheet figures. Although these tests would marginally improve the effectiveness of the Early Warning System, they would also add significantly to the complexity of understanding and using the tests. Therefore, we do not recommend that these tests be adopted. In order, however, to permit the task force to review our decision on this point, this appendix describes our:

1. Calculation of adjusted tests
2. Evaluation of adjusted tests.

**CALCULATION OF
ADJUSTED TESTS**

One essential element in the financial solidity of an insurance company is the profitability of the business. A company with unprofitable business is bound, over a period of time, to experience financial difficulty. On the other hand, a company with a cash flow problem - but with profitable business - can frequently avoid financial difficulty by raising additional capital, either in the market or through merger with a more strongly capitalized company. Thus, the underlying profitability of the business is frequently the essential question in determining whether a company can survive or must be liquidated.

During the past decade, there has been a growing consensus that statutory net gain is an inadequate measure of the true profitability of a life company, and that statutory reserves and surplus are highly conservative measures of the liabilities and net worth of the company. Concern has focused on three primary factors influencing the calculation of statutory net gain and balance sheet figures:

1. Charging off acquisition expenses as incurred rather than matching them with the premium income to which they give rise

EXHIBIT 1

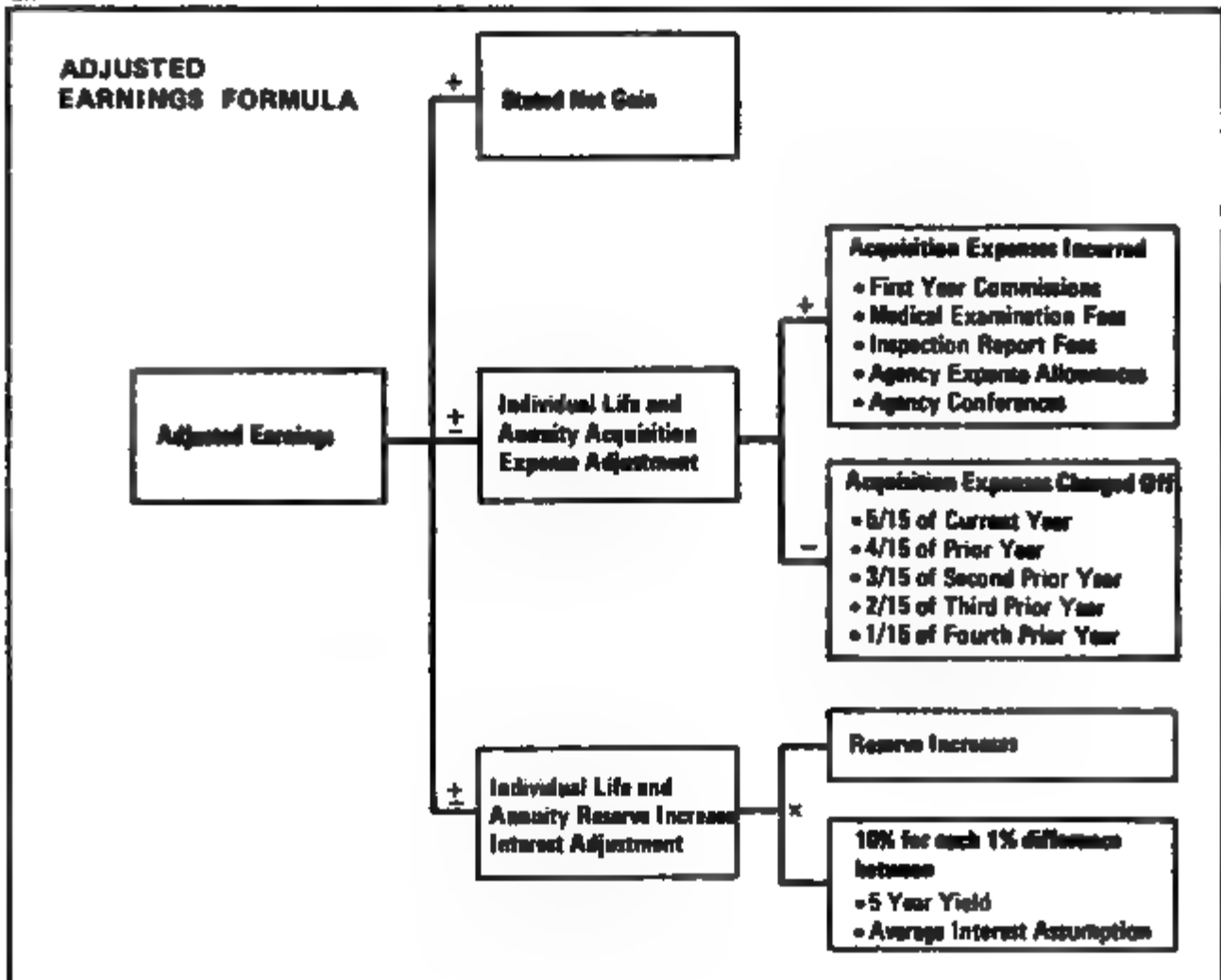
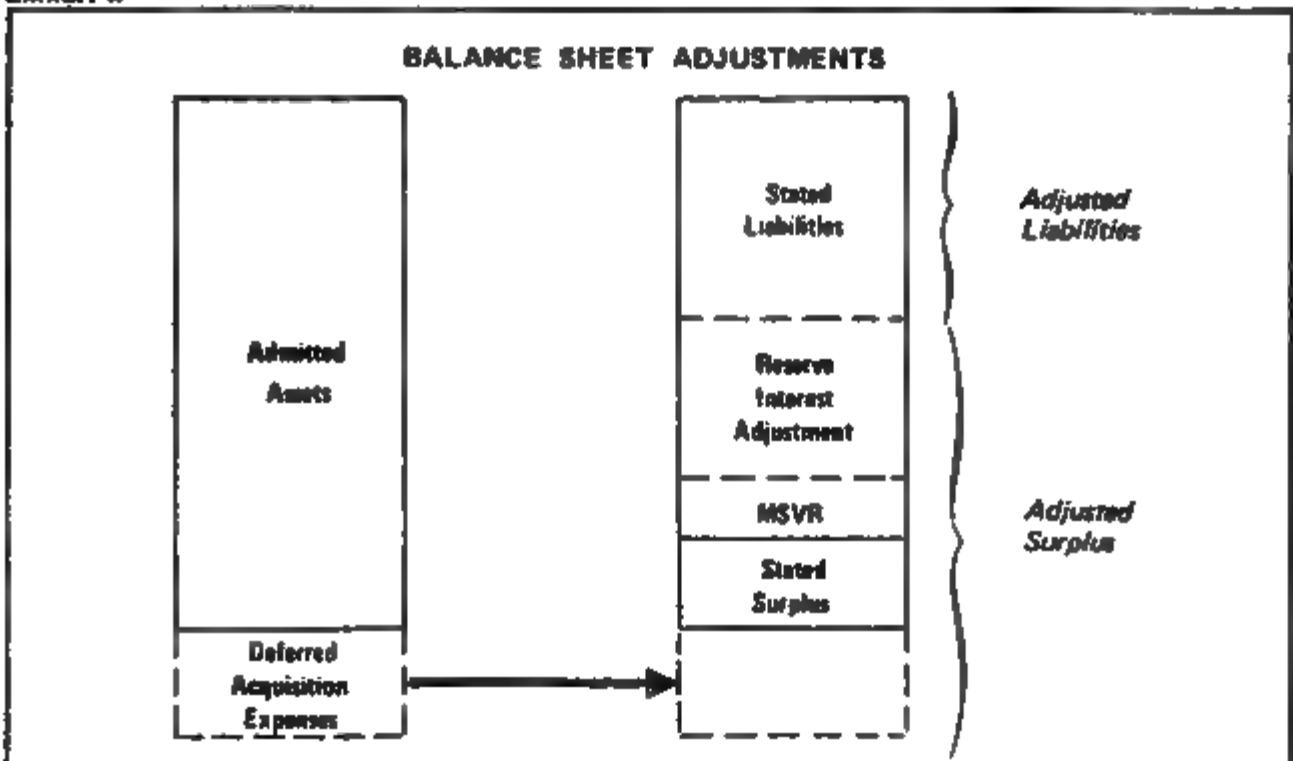


EXHIBIT 2



2. Utilizing interest assumptions, in calculating reserves and the expenses related to future benefit payments, that are well below the yield on investments experienced in recent years and anticipated in the future
3. Utilizing mortality tables derived from periods when death rates were higher than those experienced at present and anticipated in the future.

In response to these concerns, both the A. M. Best Company and the American Institute of Financial Analysts developed methods of using information available in statutory statements to adjust net gain and balance sheet figures. The two approaches are quite similar, and we have used them - with certain simplifications - to calculate adjusted earnings and balance sheet figures as components in possible early warning tests.

Our method of adjusting earnings is illustrated graphically in Exhibit I. We adjusted net gain in two ways. First, we used the sum-of-the-years-digits method to allocate individual life and annuity acquisition expenses over a five-year period. These acquisition expenses include first-year commissions, medical examination fees, inspection report fees, agency expense allowances, and agency conferences. The five-year period for charging off these expenses represents a simplification of the Best and AIFA approach, in which the period for charging off acquisition expenses depends upon the lapse rate. Since the distribution of lapse rates was found to be the same for insolvent and solvent companies, we did not believe this simplification would alter the results of the analysis. We also felt it would be most practical to begin with five years' information and build up the data base over time.

Second, we adjusted the aggregate ~~interest~~ in reserves for policies and contracts with life contingencies (excluding group insurance) for the difference between the current average reserve interest assumption and the five-year average investment yield. For the solvent companies, the five-year yield was assumed to be one-half of 1 percent less than the current yield; for the insolvents, the five-year yield was calculated from the annual statements. The reserve increase adjustment was made according to the 10-for-1 rule adopted by Best and the AIFA. This rule holds that for every percentage point of difference between the interest assumption and the investment yield, there should be a 10-point adjustment in the reserves and the increase in reserves. In order to limit the impact that this adjustment might have on companies with unusual financial results (which includes a number of the insolvents), we limited this adjustment factor to plus or minus 30 percent. Of course, if the yield is higher than the interest assumption,

EXHIBIT III

Adjusted earnings is a slightly more effective test than net gain

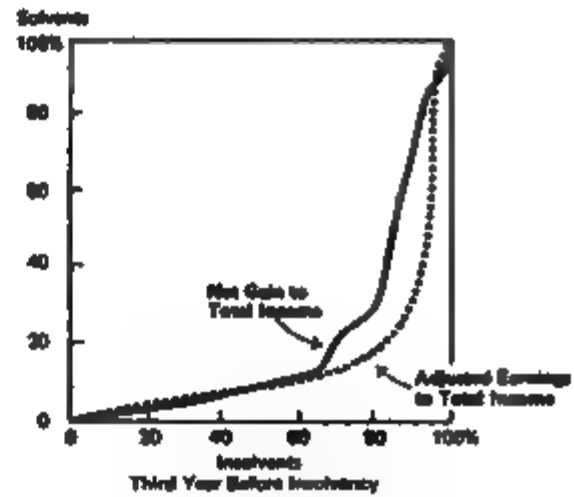


EXHIBIT IV

The adjusted and unadjusted tests of change in surplus are about equally effective 2 years before insolvency, but the unadjusted test is better in the final year

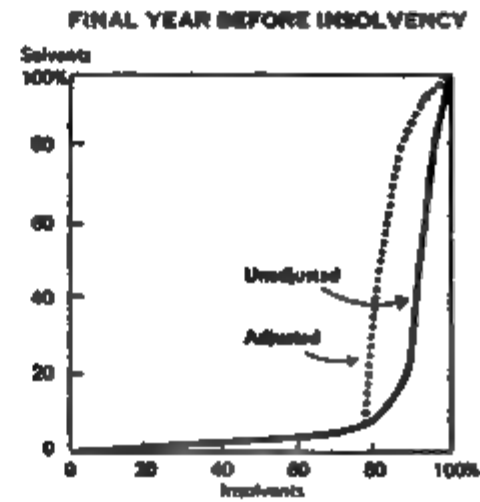
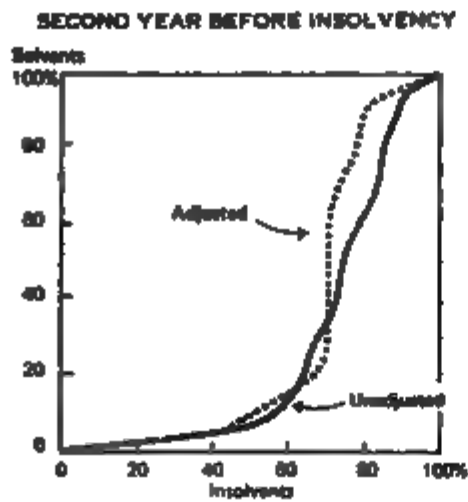
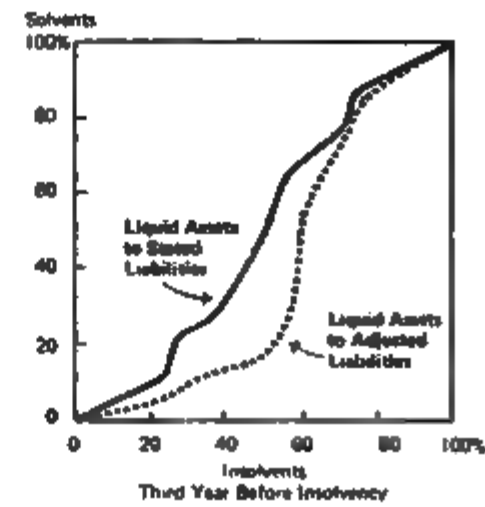


EXHIBIT V

A ratio of liquid assets to adjusted liabilities would be moderately effective, while a similar test based on stated liabilities would not be effective



the reserves and the increase in reserves are adjusted downward, and vice versa.

Following the precedent set by Best and the AIFA, we made no adjustments for conservative mortality assumptions.

Balance sheet adjustments, illustrated in Exhibit II, were made in a similar manner. Assets and surplus were increased by the amount of any acquisition expense yet to be charged off, and liabilities and surplus were adjusted for the reserve interest assumption using the 10-for-1 rule. In addition, the mandatory securities valuation reserve was deducted from liabilities and added to surplus.

We used these adjusted earnings and balance sheet figures to calculate three tests: (1) adjusted earnings to total income; (2) change in adjusted surplus; and (3) liquid assets to adjusted liabilities. In the latter, liquid assets means cash and invested assets minus any excess of investments in real estate over 5 percent of adjusted liabilities. Liquid assets might also exclude investments in affiliates, but this information was not available for most of the insolvent companies.

Exhibit III compares the ratio of adjusted earnings to total income with the ratio of net gain to total income. The adjusted earnings test is moderately superior - both when the insolvents are taken in the third year before insolvency (as shown in Exhibit III) and in other years.

The two tests of the change in surplus - adjusted and unadjusted - are shown in Exhibit IV. They are of approximately equal effectiveness when insolvents are taken in the second year before insolvency. The change in stated surplus is more effective in the insolvents' final year. For both tests, any surplus paid in during the year is deducted from the change in surplus.

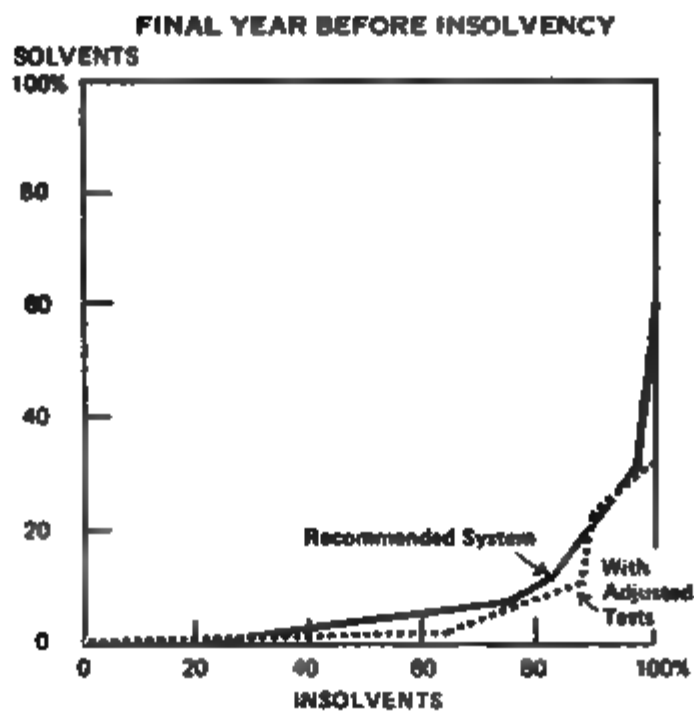
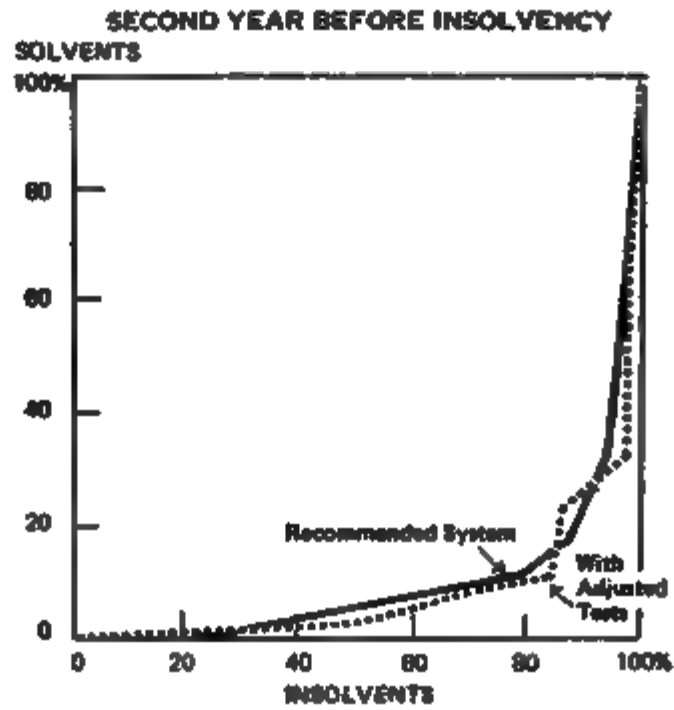
The effectiveness of the ratio of liquid assets to adjusted liabilities is shown in Exhibit V. This test has no parallel among the current tests; a similar ratio using stated liabilities would have no discriminating effectiveness, as shown in the exhibit. The ratio based on adjusted liabilities, however, is moderately effective.

EVALUATION OF ADJUSTED TESTS

In order to determine whether these adjusted tests should be employed in the Early Warning System, the significant question is not how well they

EXHIBIT VI

An early warning system based on 10 tests — including the 3 adjusted tests — would be only slightly more effective than the recommended system



each discriminate individually, but how much they would add to the discriminating effectiveness of the system as a whole.

In Exhibit VI, the nine recommended tests are compared with a system using the adjusted tests. In the latter, adjusted earnings has been substituted for net gain; change in adjusted surplus has been substituted for change in stated surplus; and the ratio of liquid assets to adjusted liabilities has been added (making a total of 10 tests). The system with the adjusted tests would be marginally more effective than the recommended system, particularly in the last year before insolvency. Thus, use of the adjusted tests could improve the effectiveness of the Early Warning System slightly. More importantly, we feel the adjusted tests are logically more adequate than the similar statutory tests.

On the other hand, including the adjusted tests has two disadvantages. Most importantly, the adjusted tests would significantly complicate the users' problem of understanding and using the Early Warning System. All of the recommended tests are relatively simple in concept and can be readily calculated by hand. The adjusted tests, however, would introduce an entirely new level of complexity into the system. We feel this added complexity might prevent some potential users from gaining the maximum benefit from the Early Warning System. Second, a data gathering problem would result from the increased period of time for which annual statement data would be required (five years as opposed to two) and the fact that some of the data required would be "new" information. Obtaining this information might depend upon the cooperation of the insurance departments in all the states and would present numerous opportunities for errors and omissions.

Thus, primarily because we believe the added complexity of the tests outweighs the very modest improvement in effectiveness, we recommend that the three adjusted tests not be employed in the Early Warning System.

USING THE LIFE AND HEALTHEARLY WARNING SYSTEMTABLE OF CONTENTS

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Appendix: Test Calculation Work Sheets

USING THE LIFE AND HEALTHEARLY WARNING SYSTEM

The Early Warning System for Life and Health Insurance Companies has been developed by an NAIC committee of state Insurance Department personnel. The purpose of the system is to help the various state Insurance Departments identify the life and health companies most likely to experience financial difficulties, so that the departments' resources for in-depth analysis and on-site examination of companies can be focused on these companies.

The system consists of nine ratios or tests that measure various aspects of the company's financial condition and stability. These tests are quite simple, yet historical analysis shows that they are effective in distinguishing between troubled and sound companies. For each test, bench marks for determining "exceptional values" - those most likely to indicate difficulty - have been established by comparing past test results for insolvent and sound companies. Depending on the number of test results that are in the exceptional value range, each company is placed in either a "priority" or a "non-priority" category.

Although the system is effective in distinguishing between troubled and sound companies, it is by no means foolproof. Therefore, important decisions - such as licensing decisions - should not be made on the basis of test results without further analysis and examination of the company concerned, and no state should rely completely on the Early Warning System as its only basis for identifying companies for priority attention.

The purpose of this manual is to assist state Insurance Department personnel in understanding how the Early Warning System operates and in gaining the maximum benefit from it. The manual consists of three chapters, covering:

1. The early warning tests
2. The priority company system
3. Suggestions for further analysis.

EXHIBIT I

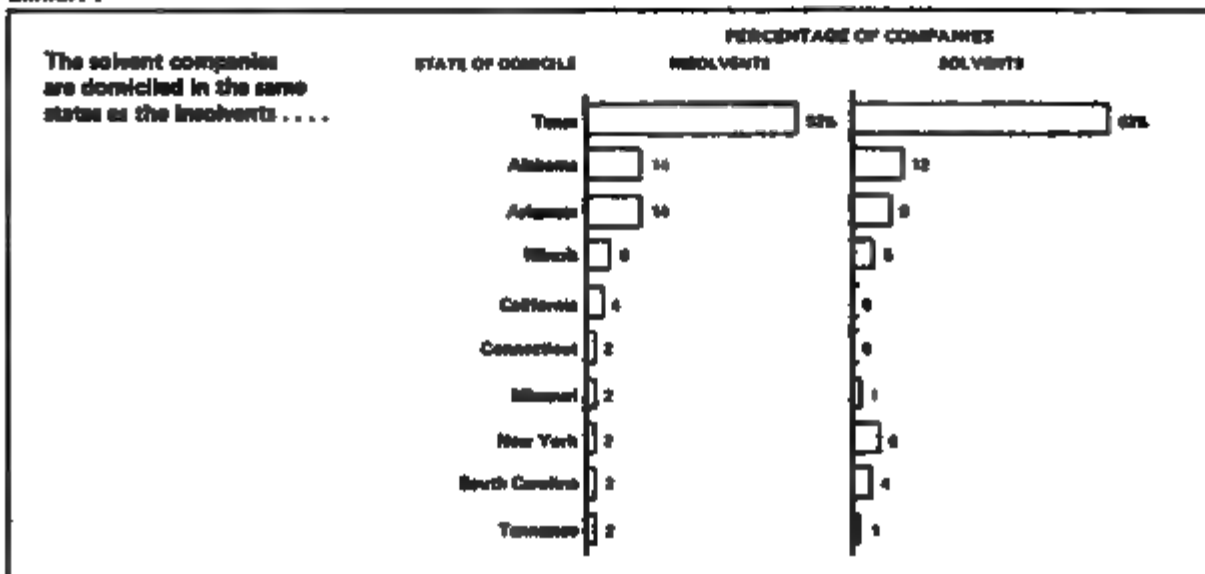


EXHIBIT II

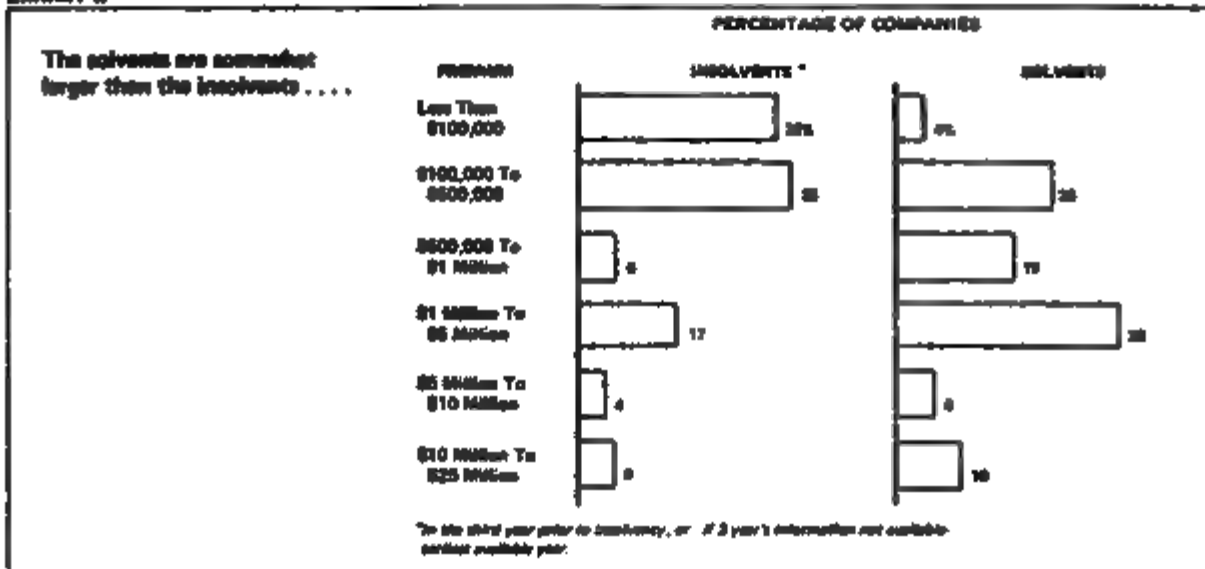
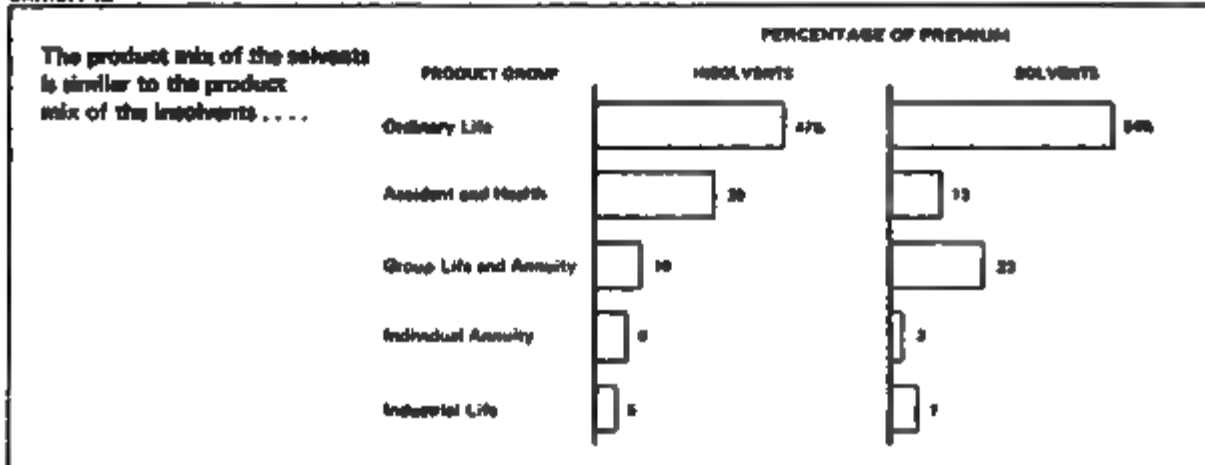


EXHIBIT III



1 - THE EARLY WARNING TESTS

The Life and Health Early Warning System is based on nine tests that have proven effective in distinguishing troubled from sound companies. The effectiveness of these tests was determined by comparing the test results for a group of insolvent companies with the results for a matched sample of solvent companies.

The insolvent company sample included 50 companies that were liquidated or came under state control during the past decade. The sample includes half of the total number of insolvent companies during that time - all of those for which annual statements were available. A sample of 85 solvent companies was matched with the insolvent sample in state of domicile (Exhibit I) and premium volume (Exhibit II), and was screened by the chief examiners in the states of domicile to eliminate clearly troubled companies. The solvents were also similar to the insolvents in product mix (Exhibit III). Of the insolvent companies, 8 percent were mutuals; six percent of the solvent companies were mutuals.

Based on the test results for these two samples of companies, benchmarks for determining exceptional values were established for each test at the point that identified the highest percentage of insolvent companies without identifying an unmanageable percentage of solvents. Exceptional values thus represent the test results that are most likely to indicate possible financial difficulty.

Work sheets for calculating test results will be found in the Appendix. These work sheets may also be helpful in clarifying the details of how the test results are calculated.

The nine early warning tests fall into two groups:

§ Financial tests

§ Stability tests.

EXHIBIT IV

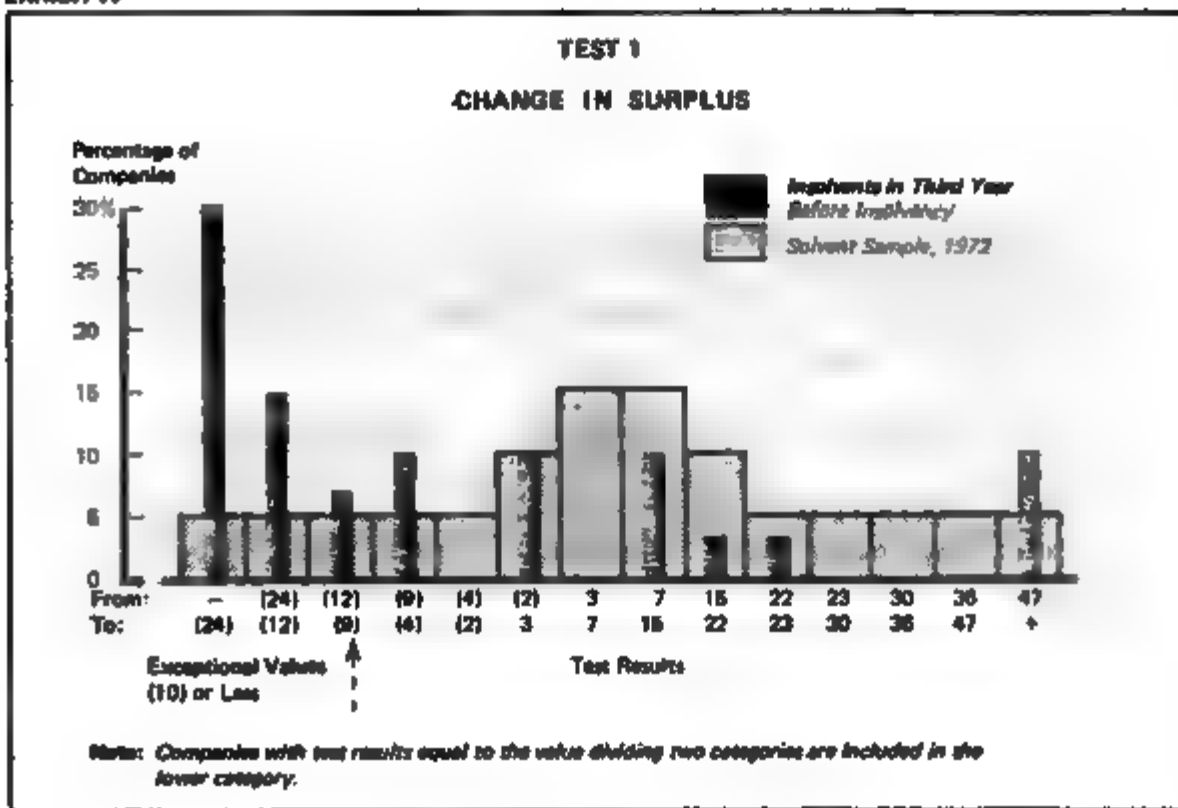
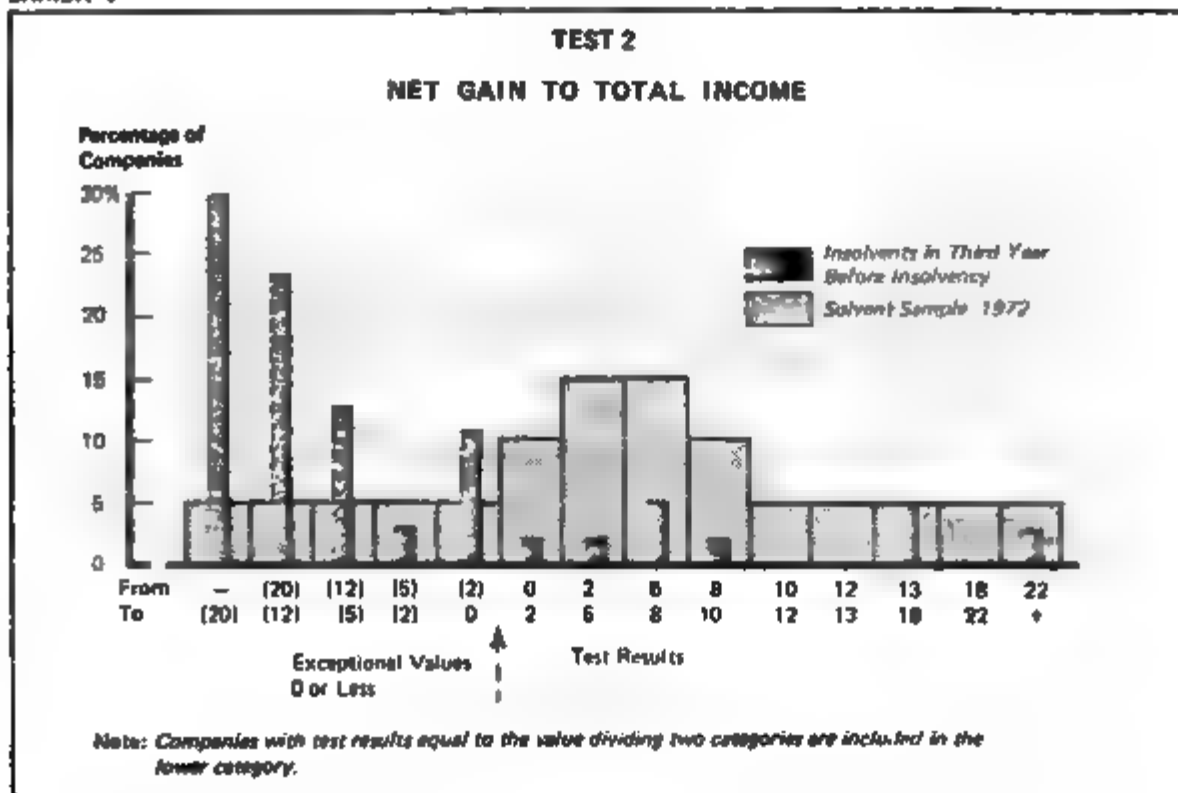


EXHIBIT V



FINANCIAL TESTS

There are five financial tests.

Change in Surplus (Test 1)

This test is the most general measure of the improvement or deterioration in the company's financial position. It is calculated by dividing the change in capital and surplus from the prior to the current year (net of any surplus paid in) by the prior year capital and surplus. Exceptional values are those less than or equal to minus 10 percent. Fifteen percent of the solvent company sample had exceptional values on this test in 1972, whereas 53 to 86 percent of the insolvent companies (depending on the number of years before insolvency) fell below the bench mark. The distribution of test results for solvent and insolvent companies is shown in Exhibit IV.

Net Gain to Total Income (Test 2)

Net gain is a conservative measure of the company's profitability. On this test, exceptional values are those less than or equal to zero. Twenty-five percent of the solvent company sample (in 1972) and 60 to 72 percent of the insolvents (depending on the period of time prior to insolvency) had exceptional values on this test. Exhibit V shows the distribution of test results for the solvent and insolvent companies.

Commissions and Expenses To Premium (Test 3)

The ratio of total commissions and general insurance expenses to premium measures is one of the key elements in profitability. The effectiveness of the test comes from the expense element; ratios of commissions to premium were found to be approximately the same for the solvent and insolvent companies. Commissions, however, are included in the test to put direct writing companies and those with branch offices on an equal footing with general agency companies. Exceptional values on this test are those greater than or equal to 60 percent (the effectiveness of the test would not be improved by relating the bench mark for exceptional values to the company's growth rate). Fifteen percent of the solvent sample

EXHIBIT VI

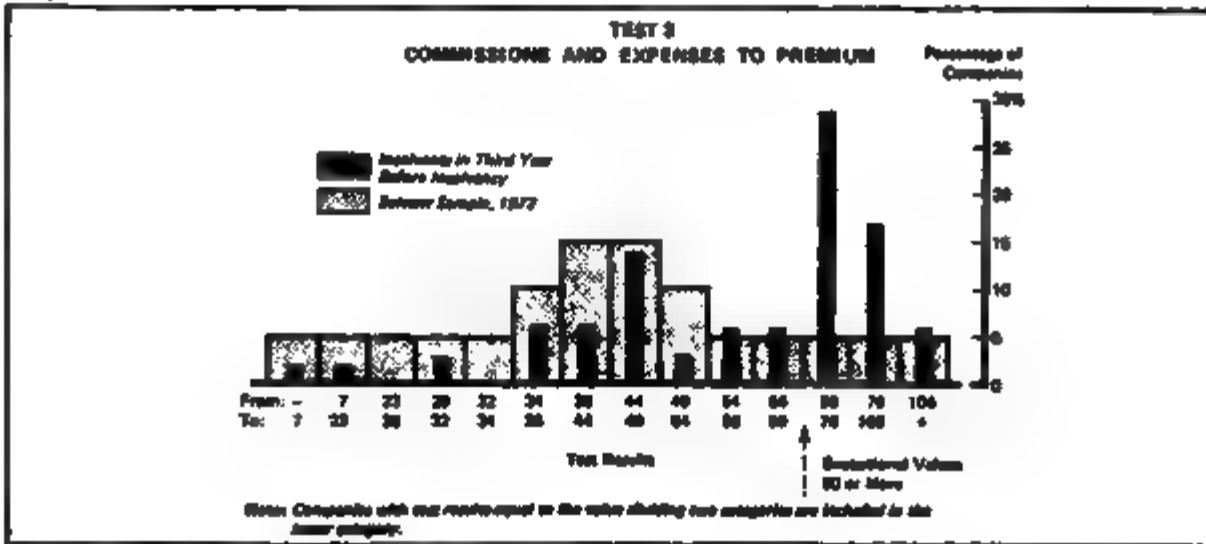


EXHIBIT VII

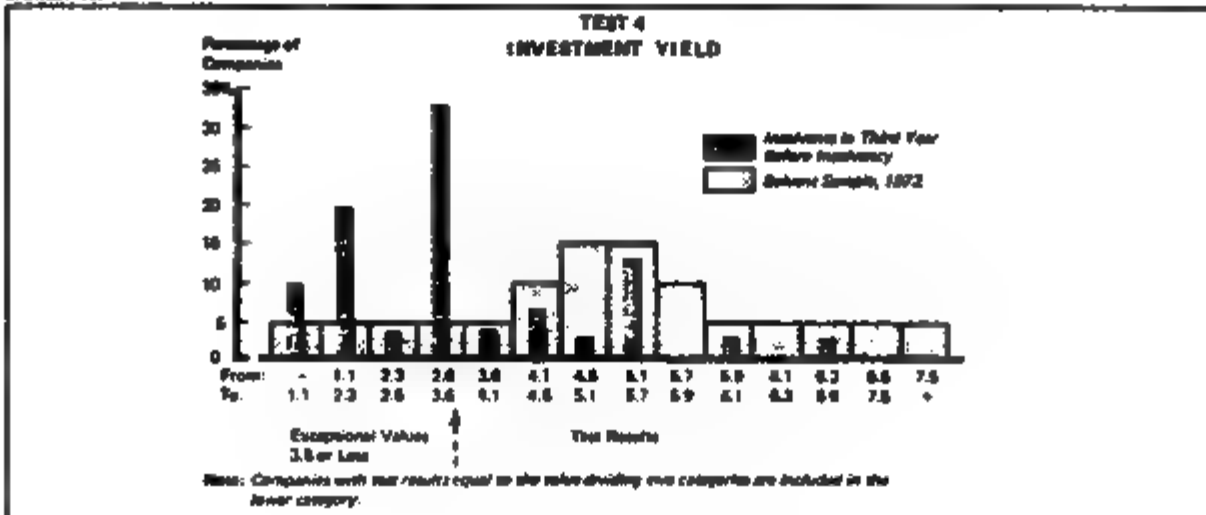
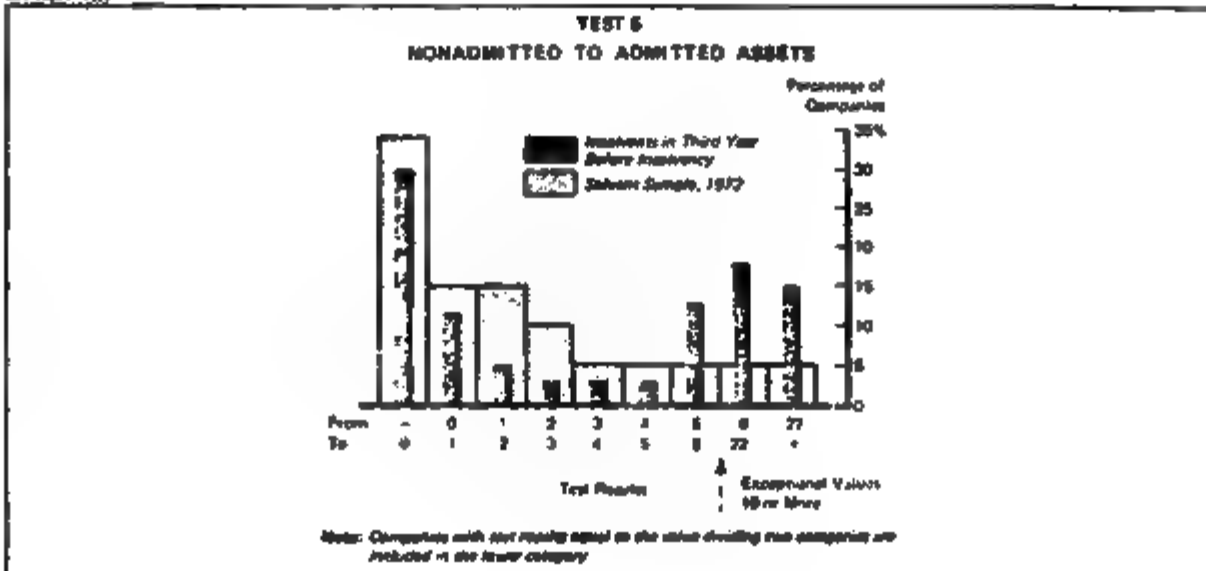


EXHIBIT VIII



(in 1972) and 52 to 61 percent of the insolvents (depending upon the year) had exceptional values on this test. Exhibit VI shows the distribution of test results for these companies.

**Investment Yield
(Test 4)**

The investment yield is another key element in the company's profitability. The test result is net investment income divided by the average amount of cash and invested assets during the year (see the work sheet in the Appendix for the method of calculating average cash and invested assets). Exceptional values are those less than or equal to 3.5 percent. Twenty percent of the solvent sample (in 1972) and 58 to 78 percent of the insolvents (depending upon the year) received exceptional values on this test. The distribution of test results for these companies is shown in Exhibit VII.

**Nonadmitted to Admitted
Assets (Test 5)**

This test measures the degree to which the company has invested in nonadmitted assets, which may represent either nonproductive or risky investments. Exceptional values are those greater than or equal to 10 percent. Nine percent of the solvent company sample (in 1972) and 26 to 43 percent of the insolvents (depending upon the year) had exceptional values on this test. Exhibit VIII shows the distribution of test results for these companies.

**STABILITY
TESTS**

Four measures of stability are included in the Early Warning System.

**Change in
Premium (Test 6)**

This test is the percentage change in premium from the prior to the current year. Exceptional values are those greater than or equal to 50 percent and less than or equal to minus 10 percent. Twenty percent of the

EXHIBIT IX

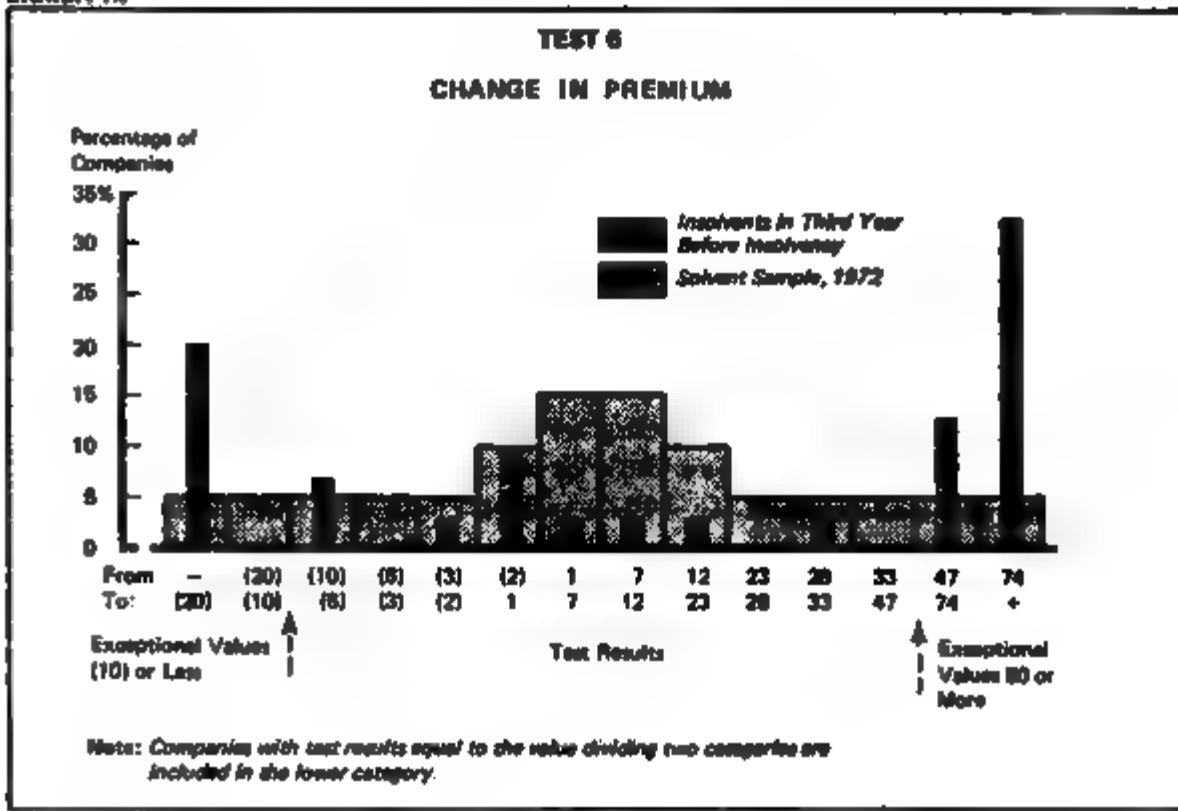
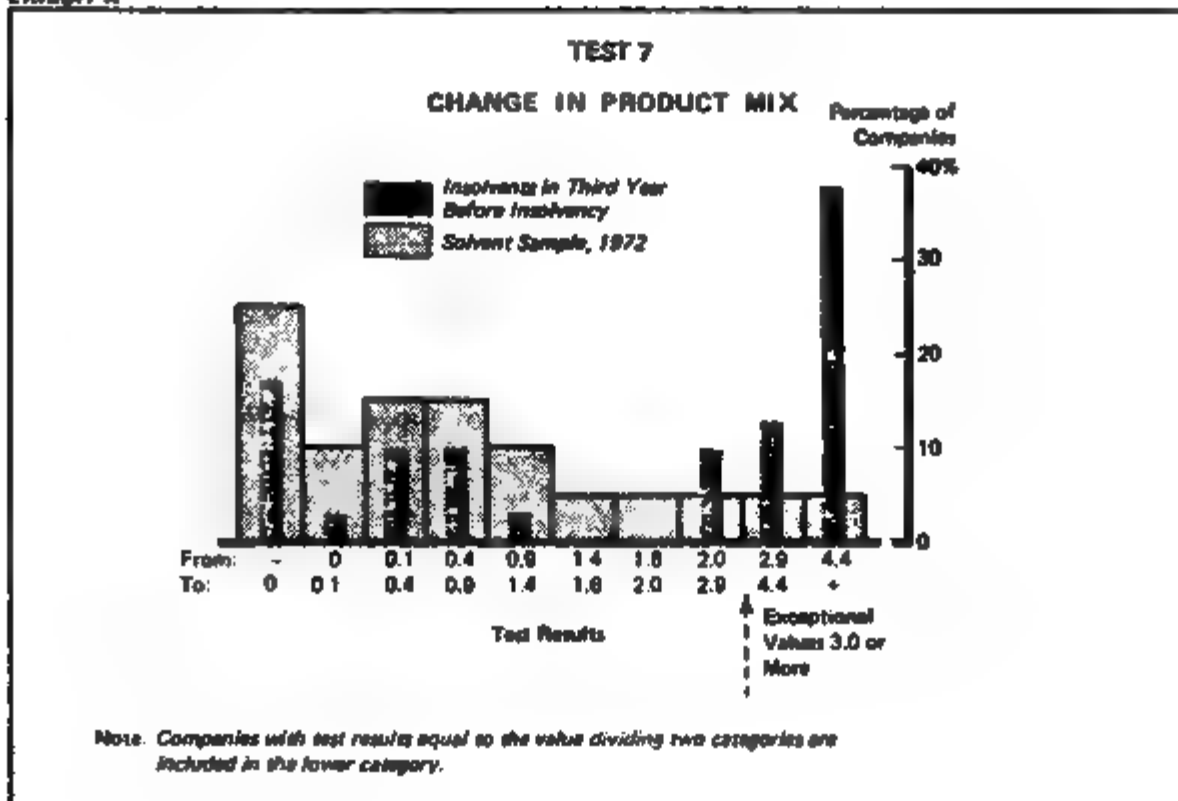


EXHIBIT X



solvent company sample (in 1972) and 65 to 75 percent of the insolvents (depending upon the period of time before insolvency) had exceptional values on this test. The insolvents tended to show dramatic increases in premium in the third or fourth year prior to insolvency, with abrupt declines in the final years. The distribution of test results for the solvent and insolvent companies is shown in Exhibit IX.

**Change in Product
Mix (Test 7)**

Results on the change in product mix test represent the average change in the percentage of total premium from each product line during the year. The product lines are those defined in the gain and loss exhibit on page 5 of the annual statement. To calculate this test result, the percentage of premium from each product line is first determined for the current and prior years. Next, the difference in the percentage of premium between the two years is determined for each product line. Finally, the total of these differences - without regard to sign - is divided by the number of product lines to determine the change in the percentage of premium for the average product line.

Due to the addition of separate columns in the gain and loss exhibit for credit life and credit disability insurance in 1973, the change in product mix test cannot be calculated for that year. For 1972 and prior years, the test result is reached in the manner described above, with ADD and TPD premium included in ordinary life for the calculation.

Exceptional values for 1972 and prior years are those greater than or equal to 3.0 percent. Twelve percent of the solvent company sample (in 1972) and 34 to 58 percent of the insolvents (depending upon the year) had exceptional values at this bench mark (Exhibit X). For 1974 and subsequent years, the bench mark for determining exceptional values will be adjusted to 5.0 percent, to reflect the increase in the number of product lines from seven to nine.

**Change in Asset
Mix (Test 8)**

The change in asset mix test is calculated in the same manner as the change in product mix. The test result represents the average change in

EXHIBIT XI

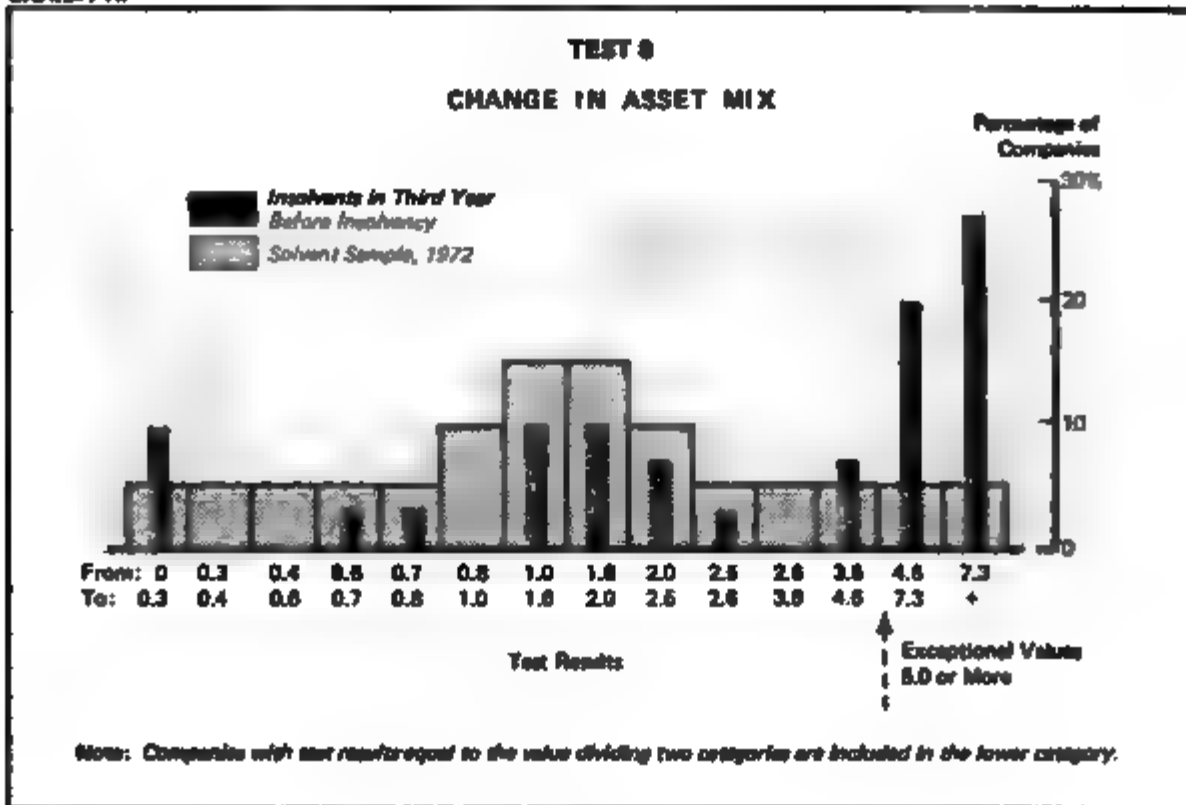
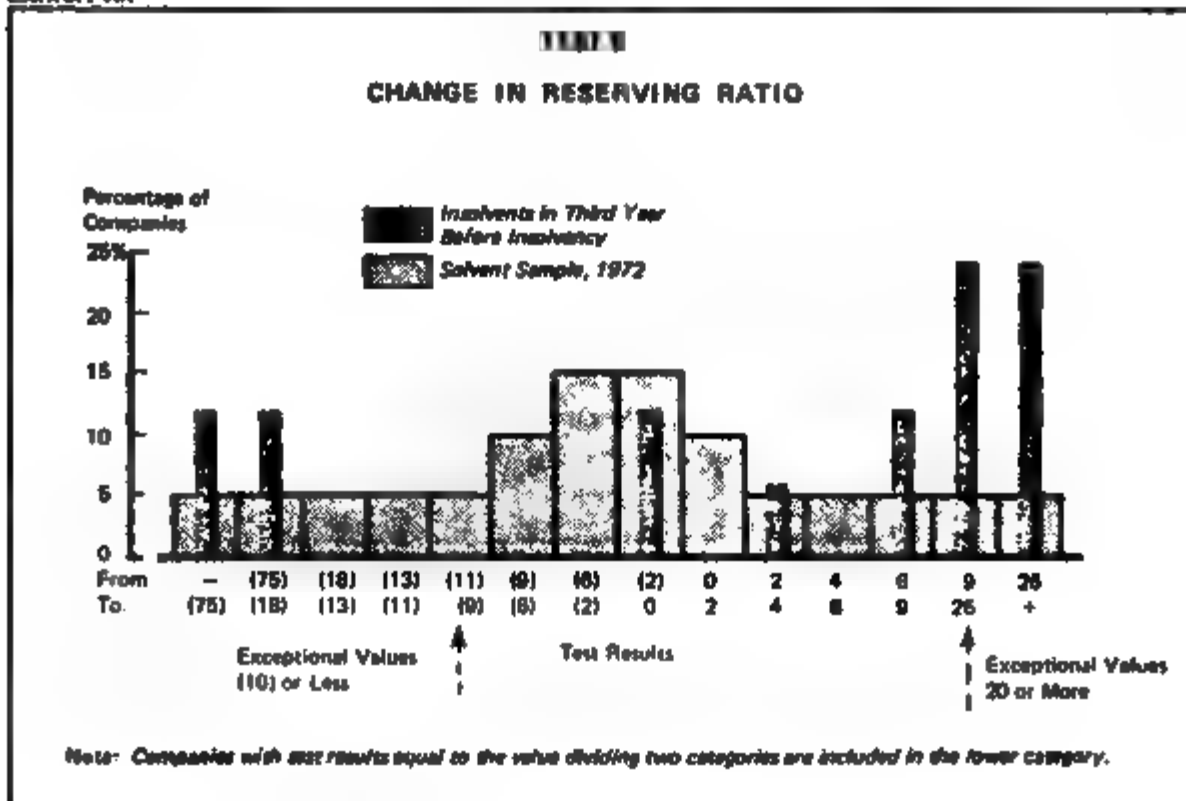


EXHIBIT XII



the percentage of total cash and invested assets for the classes of assets on the first 10 lines in page 2 of the annual statement. Exceptional values on this test are those greater than or equal to 5.0 percent. Ten percent of the solvent company sample (in 1972) and 24 to 47 percent of the insolvents (depending upon the year) had exceptional values on this test. The distribution of test results for these companies is shown in Exhibit XI.

**Change in Reserving
Ratio (Test 9)**

The change in the reserving ratio is the number of percentage points of difference between the reserving ratio for the current and prior years. For each of these years, the reserving ratio is equal to the aggregate increase in reserves for individual life insurance taken as a percentage of renewal and single premium for individual life insurance. Positive test results indicate an increase in this ratio from the prior year; negative results indicate a decrease. Exceptional values are those greater than or equal to 10 percentage points and less than or equal to minus 20 points. These bench marks identified 20 percent of the companies in the solvent sample in 1972 and about 70 percent of the insolvents in each of their last three years (60 percent in the fourth year prior to insolvency). The distribution of test results for these companies is shown in Exhibit XII.

3 - SUGGESTIONS FOR FURTHER ANALYSIS

The purpose of performing further analysis is to establish priorities for scheduling on-site examinations and to clarify the scope and focus of each examination. Particular attention should be paid to priority companies, which would receive a high priority for examination unless this analysis discloses that the company is clearly sound. Attention should also be paid to non-priority companies, however, since further analysis could disclose a need for examining some of these companies as well.

In performing additional analysis, a familiarity with the company will be most helpful. The suggestions for further analysis discussed below are not intended to be followed mechanically. Rather, the examiner should adjust the depth and direction of his analysis in accordance with his knowledge of the company and its particular circumstances.

The analysis begins with a review of the company's early warning test results. Refer to Exhibits IV through XII to determine where the company stands relative to other companies on each test. Note the tests on which the company has exceptional values and the amount by which these test results exceed or fall short of the exceptional value bench marks. Also note whether the exceptional values tend to occur on financial tests or stability tests, and refer to the appropriate section below.

FINANCIAL CONDITION

The analysis of financial condition begins with the change in surplus test, which is, in a sense, the ultimate measure of the improvement or deterioration in financial condition.

Change in Surplus

If the change in surplus ratio falls below the minus 10 percent bench mark, further analysis should first be directed at determining the reasons

2 - PRIORITY COMPANY SYSTEM

The priority designation is given to companies with exceptional values on three or more of the nine tests. Companies with less than three exceptional values are treated as nonpriority companies.

Of the 50 insolvent companies studied, all but one would have been given the priority designation at some time during their last four years. Since some insolvents would have been priority companies in some years but not others, the percentage of insolvents identified in each of the last four years before insolvency would have been about 88 percent (Exhibit XIII). Only 17 percent of the sample of solvent companies would have received the priority designation in 1972.

Overall, between 15 and 20 percent of the companies tested are expected to receive the priority company designation. These are the companies most likely to require special monitoring by the Insurance Department. Their test results should be verified, and further analysis of their annual statements should be performed to determine whether an on-site examination is called for (see Chapter 3 for suggestions on further analysis).

Although the intent of the priority company system is to assist Insurance Department personnel in focusing their immediate attention on those companies most likely to be experiencing financial difficulty, not all the priority companies will necessarily be troubled. Some may have taken action to eliminate weaknesses that became apparent during the prior year. It is also possible that unusual accounting methods may make test results appear less favorable than is warranted, or that errors may occur in calculating test results. However, unless a priority company is known to be financially sound, careful analysis and examination of that company would be appropriate.

Nonpriority companies are less likely to require in-depth review or on-site examination. However, the fact that a company is not given the priority classification by the Early Warning System should not be taken as a guarantee of continuing financial solidity. The results of individual tests for each nonpriority company should be carefully analysed. If areas of concern are identified, a review of that company's annual statement should be made to determine whether an examination is required.

3 - SUGGESTIONS FOR FURTHER ANALYSIS

The purpose of performing further analysis is to establish priorities for scheduling on-site examinations and to clarify the scope and focus of each examination. Particular attention should be paid to priority companies, which would receive a high priority for examination unless this analysis discloses that the company is clearly sound. Attention should also be paid to non-priority companies, however, since further analysis could disclose a need for examining some of these companies as well.

In performing additional analysis, a familiarity with the company will be most helpful. The suggestions for further analysis discussed below are not intended to be followed mechanically. Rather, the examiner should adjust the depth and direction of his analysis in accordance with his knowledge of the company and its particular circumstances.

The analysis begins with a review of the company's early warning test results. Refer to Exhibits IV through XII to determine where the company stands relative to other companies on each test. Note the tests on which the company has exceptional values and the amount by which these test results exceed or fall short of the exceptional value bench marks. Also note whether the exceptional values tend to occur on financial tests or stability tests, and refer to the appropriate section below.

FINANCIAL CONDITION

The analysis of financial condition begins with the change in surplus test, which is, in a sense, the ultimate measure of the improvement or deterioration in financial condition.

Change in Surplus

If the change in surplus ratio falls below the minus 10 percent bench mark, further analysis should first be directed at determining the reasons

behind the decline in surplus and the likelihood that they will be repeated in future years. Review the surplus account on page 4 of the annual statement. If the only significant decrease in surplus was a net loss from operations, refer to the suggestions under net gain in the following section. Other factors likely to have a significant negative impact on surplus include:

1. Stockholder dividends. Was the amount of dividends paid to stockholders appropriate, considering the company's net gain and general financial condition? If the company made a net loss, were dividends reduced? Has the company's dividend policy over the past five years been consistent with protecting the company's ability to meet its financial obligations to policyholders?
2. Capital losses. Check Exhibit 4 to determine which categories of investments were responsible for capital losses. Were the company's losses generally in line with the losses experienced by other companies investing in the same classes of assets during the same period? How are the company's assets currently invested (review page 2 and Schedules A through D)? Has the company moved to protect itself against further capital losses?
3. Increases in reserves due to valuation changes. Review Exhibit 8A and check the company's result on Test 9, the change in the reserving ratio. Also review the results of the department's last reserve valuation check. If the company appears to have been under-reserved, did the recent change in valuation bases correct the problem, or may further decreases in surplus be required?
4. Losses from nonadmitted assets. Determine, from Exhibit 14, the source of the losses. Check the company's result on Test 5 (nonadmitted to admitted assets) and refer to the suggestions for further analysis under the section on investments below.

Also determine, from the surplus account on page 4, the amount of any increases in surplus. Determine whether these increases partially masked decreases in surplus (bear in mind that surplus paid in is netted

out of the change in surplus ratio) and whether these increases are likely to be repeated in future years.

Net Gain

Check the trend in the ratio of net gain total income (Test 2) and review the gain or loss by product line on page 5, bearing in mind that the company has considerable discretion in allocating expenses among product lines. If a company's losses result from a few product lines, the following analysis may be done for only those lines of business.

Three principal factors affect the company's net gain:

1. Mortality and morbidity. Review the trend in benefits paid (page 5, lines 8 through 11) as a percentage of premiums, by product line. If these ratios have increased, consider requesting supplemental information on mortality and morbidity experience, and consult the department's actuary to determine the financial implications of the company's mortality and morbidity experience.
2. Increases in reserves. Check the amount of change in the ratio of reserve increases to renewal and single premium for individual life insurance (Test 9). In addition, compare the company's investment yield (Test 4) in recent years with the average reserve interest assumption. (The average interest assumption must be calculated from Exhibit 8; tabular interest given on page 6 is frequently inaccurate.) If the yield is significantly less than the interest assumption, the probability of financial difficulty is high, and the increase in reserves understates the true expense associated with future benefit payments. On the other hand, if the yield is above the interest assumption, the business will probably be more profitable, ultimately, than is indicated by the current net gain or loss.
3. Commissions and expenses. Refer to the next section.

Commissions And Expenses

Review the trend in the ratio of commissions and expenses to premium (Test 4). A high ratio of commissions and expenses to premium can be caused by excessive spending or a high growth rate. For companies with exceptional values (above 60 percent) on this test, further analysis should first be directed at determining the relative importance of these two factors.

In addressing this issue, it is helpful to compare the subject company with a group of three to five natural competitors that have test results below 60 percent. These companies should be of about the same size and sell about the same products as the subject company. They should also have a similar mix of general agencies and branch offices - since this affects the balance between commissions and expenses. For each company, calculate for the past five years:

1. New premium to total premium
2. First-year commissions to first-year premium
3. Single and renewal commissions to single and renewal premium
4. General insurance expenses to total premium.

Comparison of the subject company with its competitors on these ratios will disclose the relative contribution of growth and spending levels to the high test result, as well as the relative importance of expenses and commissions.

In general, the insolvent companies studied tended to have higher ratios of expenses to premium than the solvents, whereas the ratios of commissions (new and renewal) to premium were about the same for the two groups of companies.

If the underlying reason for the high test result is excessive spending, particularly in the category of general insurance expenses, familiarity with company management may be of help in interpreting the importance of this fact. Loose control over expenses in general may not pose an immediate threat to solvency. However, excessive spending might also indicate that management's attitudes and objectives are not consistent

with the long term financial security of policyholders. A "free-spending" attitude was evident in a number of the insolvent companies studied.

If the underlying reason for the high test result was the growth rate, continuation of rapid growth may dangerously reduce surplus and necessitate raising additional capital. The general soundness of the company and the profitability of its operations could then be crucial to raising this additional capital. If the company is unlikely to attract new capital, a high growth rate and declining surplus could threaten the company's solvency.

Investments

For life companies, investments represent a particularly critical element in company performance and solidity. Familiarize yourself with the company's investments on page 2 of the annual statement, and check the company's results on the test of change in asset mix (Test 8) to determine the stability of the company's investment policy.

Check the ratio of nonadmitted to admitted assets (Test 5). For companies with test results above 10 percent, review Exhibits 13 and 14 to determine the nature of the nonadmitted assets and the reasons for nonadmission. Compare the amount of nonadmitted assets with surplus to determine the impact on financial condition of the investments in nonadmitted assets.

Also, check the amount of investments in affiliated companies (Schedule D summary page) as a percentage of invested assets. If the amount is high, the company may experience a low yield or illiquidity. Large investments in affiliated companies may also increase the overall risk to which the company is subject. Determine whether the company's investment in affiliates is consistent with protecting the interests of policyholders.

It is helpful to consider the company's investments from three points of view:

1. Risk. Certain classes of investments are generally more risky than others. For example, equity investments (such as stocks and real estate) tend to experience greater fluctuations in value than investments in debt (such as bonds and mortgage loans). Review the company's mix of assets. Compare the percentage of invested assets in equities with the ratios for

similar companies. Also check the amount of the mandatory securities valuation reserve as a percentage of investments in stocks.

2. **Return.** The basic measure of return for insurance companies is the investment yield (Test 4). For companies with a low yield, first compare the yield with the average reserve interest assumption (see the section on net gain). Then determine from Exhibit 3 the gross yield on each of the major classes of assets. This will clarify the degree to which the low overall yield may be due to large investments in assets that produce little or no current income. Some companies may forego a certain amount of current income in the expectation of capital gains. Therefore, also compare the company's capital gains and losses, by type of investment (from Exhibit 4), with other companies over a period of several years. If the company has experienced large gains or losses, review Schedules A through D and attempt to determine whether the company's investments may be unduely speculative.
3. **Liquidity.** In general, investment liquidity is less important for life companies than for accident and health and property-liability companies, due to the long term nature of the life insurance contract. However, liquidity may also be important for life companies with a mature book of business and declining new sales. Debt investments tend to be less liquid than stocks; the liquidity of real estate holdings may be difficult to determine. Review the distribution of the company's assets from the point of view of liquidity and determine whether the investments are sufficiently liquid to meet possible cash demands, given the nature of the company's business.

STABILITY

In judging the significance of exceptional values on the stability tests, familiarity with the company's history, management, and operations is of particular importance. If a company increases or decreases its premium rapidly, changes its mix of products or assets, or alters its ratio of reserve increases to premium, the key questions become: Does the company's management know what it is doing? Is management in control

of the situation? Does the company have the knowledge and experience required to maintain financial strength while operations are changing dramatically? Financial analysis is of little assistance in answering these questions. Therefore, an examination is probably required for companies with exceptional values on two or more of the stability tests - unless the insurance department is completely satisfied that the answer to the above questions is yes.

A change in direction, as may be indicated by the stability tests, may result from a change in company ownership and control. During the past decade, two thirds of the insolvent life and health companies had had their current owners for five years or less at the time of insolvency. Of all life and health companies in 1972, only 8 percent had had their current owners five years or less. These facts suggest that life and health companies should receive high priority for examination during their first years under new ownership.

TEST CALCULATION WORK SHEETS

The work sheets on the following pages can be used to calculate test results by hand and to clarify the details of the calculations. The data required for test calculations are referenced by page, column, and line in the association blank.

Work Sheet 1

Company _____

Year _____

TEST 1: CHANGE IN SURPLUS

1. Page 3 Line 30 Current Year* _____
2. Page 4 Line 39 Current Year _____
3. Page 3 Line 30 Prior Year* _____
4. Line 1 - Line 2 - Line 3 _____
5. Test Result (Line 4 ÷ Line 3) _____%

* If Line 1 or Line 3 above is zero or negative, the test result is - 99 percent.

TEST 2: NET GAIN TO TOTAL INCOME

1. Page 5 Column 1 Line 33 _____
2. Page 5 Column 1 Line 7* _____
3. Test Result (Line 1 ÷ Line 2) _____%

* If Line 2 above is zero or negative, no test result is calculated.

TEST 3: COMMISSIONS AND EXPENSES TO PREMIUM

1. Page 5 Column 1 Line 21 _____
2. Page 5 Column 1 Line 23 _____
3. Line 1 + Line 2 _____
4. Page 5 Column 1 Line 1* _____
5. Test Result (Line 3 ÷ Line 4) _____%

* If Line 4 above is zero or negative, no test result is calculated.

Work Sheet 2

Company _____

Year _____

TEST 4: INVESTMENT YIELD

The investment yield is called for in the association blank in Exhibit 2 Line 8. If not shown, the yield can be calculated as follows:

Current Year Statement

1. Page 2 Line 10A _____
2. Page 2 Line 19 _____
3. Page 3 Line 23 _____
4. Line 1 ÷ Line 2 – Line 3 _____

Prior Year Statement

5. Page 2 Line 10A _____
6. Page 2 Line 19 _____
7. Page 3 Line 23 _____
8. Line 5 ÷ Line 6 – Line 7 _____

Test Result

9. Page 5 Column 1 Line 4 Current Year _____
10. Line 4 ÷ Line 8 – Line 9 _____
11. Half of Line 10* _____
12. Test Result (Line 9 ÷ Line 11) _____ %

* If Line 11 above is zero or negative, no test result is calculated.

TEST 5: NONADMITTED TO ADMITTED ASSETS

1. Page 14 Column 3 Line 26 _____
2. Page 14 Column 4 Line 26* _____
3. Test Result (Line 1 ÷ Line 2) _____ %

* If Line 2 above is zero or negative and Line 1 is positive, the test result is 999 percent.

TEST 6: CHANGE IN PREMIUM

1. Page 5 Column 1 Line 1 Current Year* _____
2. Page 5 Column 1 Line 1 Prior Year* _____
3. Line 1 – Line 2 _____
4. Test Result (Line 3 ÷ Line 2) _____ %

* If both Line 1 and Line 2 above are zero or negative, test result is zero.
If only Line 2 is zero or negative, test result is 999 percent.

Work Sheet 3

Company _____

Year _____

TEST 7: CHANGE IN PRODUCT MIX*Note: Due to changes in the association blank, this test can not be calculated for 1973.***1972 AND PRIOR YEARS:**

PREMIUM	CURRENT YEAR		PRIOR YEAR		Column 2 Minus Column 4
	Amount	Percentage of Total	Amount	Percentage of Total	
	1	2	3	4	
Page 5 Line 1					5
Column 2	_____	_____	_____	_____ %	_____ %
Col. 3+4+5	_____	_____	_____	_____	_____
Column 6	_____	_____	_____	_____	_____
Column 7	_____	_____	_____	_____	_____
Column 8	_____	_____	_____	_____	_____
Column 9	_____	_____	_____	_____	_____
Column 10	_____	_____	_____	_____	_____
Column 11	_____	_____	_____	_____	_____
Total Column 1*	_____	_____	_____	_____	_____
Total, without regard to sign, of percentages in Column 5.					_____ %
Test Result: Above total ÷ 9.					_____ %

1974 AND SUBSEQUENT YEARS

PREMIUM	CURRENT YEAR		PRIOR YEAR		Column 2 Minus Column 4
	Amount	Percentage of Total	Amount	Percentage of Total	
	1	2	3	4	
Page 5 Line 1					5
Column 2	_____	_____	_____	_____ %	_____ %
Column 3	_____	_____	_____	_____	_____
Column 4	_____	_____	_____	_____	_____
Column 5	_____	_____	_____	_____	_____
Column 6	_____	_____	_____	_____	_____
Column 7	_____	_____	_____	_____	_____
Column 8	_____	_____	_____	_____	_____
Column 9	_____	_____	_____	_____	_____
Column 10	_____	_____	_____	_____	_____
Column 11	_____	_____	_____	_____	_____
Total Column 1*	_____	_____	_____	_____	_____
Total, without regard to sign, of percentages in Column 5.					_____ %
Test Result: Above total ÷ 9.					_____ %

* If total premium (Page 5 Column 1 Line 1) is zero or negative for either the current or the prior year, no test result is calculated.

Work Sheet 4

Company _____

Year _____

TEST 8: CHANGE IN ASSET MIX

ASSETS	CURRENT YEAR		PRIOR YEAR		Column 2 Minus Column 4
	Amount	Percentage of Total	Amount	Percentage of Total	
Page 2	1	2	3	4	5
Line 1	_____	_____%	_____	_____%	_____%
Line 2	_____	_____	_____	_____	_____
Line 3	_____	_____	_____	_____	_____
Line 4	_____	_____	_____	_____	_____
Line 5	_____	_____	_____	_____	_____
Line 6	_____	_____	_____	_____	_____
Line 7	_____	_____	_____	_____	_____
Line 8	_____	_____	_____	_____	_____
Line 9	_____	_____	_____	_____	_____
Line 10	_____	_____	_____	_____	_____
Total Line 10A	_____	_____	_____	_____	_____
<i>Total, without regard to sign, of percentages in Column 5</i> <i>Test Result: Above total + 10</i>					_____% _____%

Work Sheet 5

Company _____

Year _____

TEST 9: CHANGE IN RESERVING RATIO

Note: To calculate test results for 1973, use the current year column at the bottom and the prior year column at the top of this work sheet.

	<u>CURRENT YEAR</u>	<u>PRIOR YEAR</u>
1972 AND PRIOR YEARS' RESERVING RATIOS		
1. Page 5 Column 2 Line 17	_____	_____
2. Page 5 Column 3 Line 17	_____	_____
3. Page 5 Column 4 Line 17	_____	_____
4. Page 5 Column 5 Line 17	_____	_____
5. Line 1 ÷ Line 2 ÷ Line 3 ÷ Line 4*	_____	_____
6. Page 7 Column 2 Line 10	_____	_____
7. Page 7 Column 3 Line 10	_____	_____
8. Page 7 Column 4 Line 10	_____	_____
9. Page 7 Column 5 Line 10	_____	_____
10. Page 7 Column 2 Line 19	_____	_____
11. Page 7 Column 3 Line 19	_____	_____
12. Page 7 Column 4 Line 19	_____	_____
13. Page 7 Column 5 Line 19	_____	_____
14. Sum of Lines 6 through 13*	_____	_____
15. Line 5 ÷ Line 14	_____ %	_____ %
1973 AND SUBSEQUENT YEARS' RESERVING RATIOS		
16. Page 5 Column 2 Line 17	_____	_____
17. Page 5 Column 3 Line 17	_____	_____
18. Line 16 ÷ Line 17**	_____	_____
19. Page 7 Column 2 Line 10	_____	_____
20. Page 7 Column 3 Line 10	_____	_____
21. Page 7 Column 2 Line 19	_____	_____
22. Page 7 Column 3 Line 19	_____	_____
23. Line 19 ÷ Line 20 ÷ Line 21 ÷ Line 22**	_____	_____
24. Line 18 ÷ Line 23	_____ %	_____ %
CHANGE IN RATIO		
25. Current year ratio from Line 15 or Line 24		_____ %
26. Prior year ratio from Line 15 or Line 24		_____ %
27. Test result (Line 25 - Line 26)		_____ Points

* If both Lines 5 and 14 above are zero or negative, Line 15 is zero. If Line 14 is zero or negative and Line 5 positive, Line 15 is 100 percent.

** If both Lines 18 and 23 above are zero or negative, Line 24 is zero. If Line 23 is zero or negative and Line 18 is positive, Line 24 is 100 percent.

Senator BROOKE. All right. Now is there a nationally recognized definition of what constitutes an insurance company insolvency?

Mr. KINDER. I think there are nationally recognized definitions. The NAIC model, "Post-Assessment Guarantee Fund" defines an insolvent insurer as an insurer determined to be insolvent by a court of competent jurisdiction, and we believe the determination of the insolvency will always be a question of judgment and petitions for the determination of insolvency are generally opposed by the alleged insolvent insurer.

I have a case in California where we began conservatorship in a company on September 23, 1975, and the matter is still in litigation with the owners of the company contesting our allegations and we do not have hopes for an early resolution of that problem.

Senator BROOKE. What is your definition of "insolvency"?

Mr. KINDER. My definition of "insolvency"?

Senator BROOKE. Your association's definition?

Mr. KINDER. The definition of "insolvency" would clearly be an excess of liability over assets, but we deal in insurance terminology with a distinction between what might be termed a "commercial insolvency" and a "statutory insolvency." A "statutory insolvency," is the impairment of capital. That is, the exhaustion of the surplus above capital so capital becomes impaired.

Senator BROOKE. How many of the insurance company insolvencies which have occurred since 1970 have not been covered by State guarantee funds and what is the extent of the losses to policyholders and claimants of these failed companies?

Mr. KINDER. We do not have that information for you this morning, Senator. We are in the process of gathering it and we will develop it fully and submit it to this committee.

I think there are probably two areas here. One is the extent to which the existing guarantee funds leave certain liabilities uncovered, and the other would be insolvencies in those States prior to the time that they enacted guarantee funds in the time period for which you requested this information.

Senator BROOKE. Will you submit that number for the record?

Mr. KINDER. Yes, sir.

Senator BROOKE. We would like to have that. To what extent have policyholders of insolvent companies covered by State guarantee funds or their claimants not been compensated for losses due to deductibles and maximum recovery limits imposed by State guarantee plans?

Mr. KINDER. Here again, we do not have the specific answer to your question. There are deductibles in most, if not all, of the guarantee fund of \$100 or \$200 per claim.

In addition, some of the States do not cover unearned premium liabilities. The California Guarantee Act does not, for example. Other States with the NAIC model bill have a maximum recovery of \$300,000. In California that is \$500,000. I know of no insolvency in which we have had a single claim in excess of that amount, but this is information that we will have to gather from a number of sources and we will submit it for you.

Senator BROOKE. In the event of the insolvency of a major company, what procedures have been developed for distributing the assets of

such a company among the guarantee funds in the States in which the company was doing business?

Mr. KINDER. At this point at least 18 States now have early access provisions, allowing the guarantee funds immediate access to any assets still held by the insolvent insurer. This obviously substantially reduces the assessment burdens of the fund system.

There are a number of other States in which such legislation is pending, including California in the current session.

Early access is provided by the new draft model liquidation law which the NAIC has. It is also expected to be acknowledged in an amendment to the NAIC model guarantee funds law.

Another significant revision is the assurance of priority for guarantee fund claims in the insolvency or liquidation proceedings. The guarantee fund in this sense represents the consumer claimants and policyholders, who should be entitled to a priority over general creditors. At least 16 States have already added such priority provisions to their guarantee funds, and this change is soon expected to be incorporated into the NAIC model bill. I believe at the December meeting of the association that will be accomplished.

Senator BROOKE. Have you actually worked on procedures for distributing the assets of such a company?

Mr. KINDER. Well, it would require that it be accomplished in the fashion I have described, the liquidation task force has worked on the procedural aspect of it as well.

Senator BROOKE. Will you submit that in detail to this committee?

Mr. KINDER. Yes, sir.

Senator BROOKE. In most States both property liability and life and health guarantee funds have been proposed in approximately the same time frame. The data we have indicates that only 17 States have adopted life and health guarantee laws, whereas 48 States have property liability guarantee laws.

Why has the adoption of life and health guarantee laws lagged so far behind adoption of property liability laws?

Mr. KINDER. I think the principal reason for that, Senator, is the lack of a perceived need for such a guarantee fund. The record in those lines of business has been such that there have been relatively few insolvencies.

Additionally, the long-term nature of life contracts and reinsurance and statutory reserves minimize the solvency problems in this line. In California we do not have a life guarantee fund. My own efforts over the last three legislative sessions to gain the enactment of such a fund have been unrewarding. I think that we will continue to make that effort, but again the legislators seem to look at the past record and find that they do not see a need for this kind of legislation.

Senator BROOKE. Why do you think the need exists?

Mr. KINDER. I think that in California we have had one life insolvency over the last 7 or 8 years, that resulted in a very modest loss, like about \$300,000, to policyholders, and it is my belief that we should make provision to take care of that, although it is small in significance to the total amount of life premiums; I think those policyholders should have that protection.

Senator BROOKE. Why don't you use that same reasoning as far as S. 1710 is concerned? Couldn't you apply that same reasoning, that the potential danger is there?

Mr. KINDER. I think we are talking about two potentialities, one is the potential of any loss, and the other is the loss that would exceed the amount of funds available to the State guarantee fund.

Senator BROOKE. I quite agree. But I am saying the same reasoning could be applied here.

Mr. KINDER. Well, if it is only a difference in degree, I would submit it is a rather significant degree.

Senator BROOKE. An article by Jack H. Blaine, appearing in the spring 1977 edition of *Forum*, said that State guarantee plans seem to be plagued by constitutional and other legal problems.

Would these serious and continuing legal difficulties compromise the effectiveness of State guarantee funds?

Mr. KINDER. Here again, Senator, we have not had an opportunity to complete our research into that area. There have been certain challenges, and I believe in at least one State the guarantee act that had initially been enacted was found to be unconstitutional.

I don't believe that it does offer a promise of serious and continuing legal difficulties, but it is something that should be reviewed and we will give you a complete review.

Senator BROOKE. You are making that review?

Mr. KINDER. Yes, sir.

Senator BROOKE. Will you submit your findings?

Mr. KINDER. We shall.

Senator BROOKE. Now you state if the Federal antitrust laws were applied, insurers continued ability to pool information would be thrown into doubt, and you cite the *Container* case.

But if this is true, could the antitrust law not be amended by the Congress to permit such legitimate pooling?

Mr. KINDER. I would think it could be, yes.

Senator BROOKE. You state that the prime movers for the adoption of open competition laws are certain insurers who want more freedom to increase prices. Is that right?

Mr. KINDER. I believe that that is correct. I think that is where the strong pressure for open competition lies.

Senator BROOKE. Isn't that unfair to the proponents of open competition?

Mr. KINDER. I would characterize myself as a proponent of open competition, Senator. It seems obvious that if under a prior approval system that is administered stringently, if the rates there are fully adequate, that there would not be a pressure for open competition.

Senator BROOKE. How has open competition worked in California?

Mr. KINDER. I think it has worked rather well. We have had open competition on all property and liability lines since 1947. We have not made a review within the last several years on a comparative basis; but, earlier we had done this kind of review on several occasions, and we found a condition to exist which is roughly that on lines of business that were losing lines of business, countrywide, the margin of loss in California was less than it was in the average of other States. And that on those lines of business that were profitable countrywide, the margin of profit in California was less.

We interpreted this to suggest that the open competition law allowed the insurers to adjust their prices as the evidence emerged to suggest

that they were pricing it either too high or too low, and it therefore avoided the extremes.

Senator BROOKE. According to the Justice Department, open competition has served consumers in your State of California very well. You seem to agree with that.

Mr. KINDER. Yes, sir; I believe it has.

Senator BROOKE. Mr. Chairman, I know we have another panel. I will defer the rest of the questions and will submit them to the Commissioners for the record.

[The following was received for the record:]

JAMES M. STONE, MASSACHUSETTS COMMISSION OF INSURANCE, RESPONSE TO QUESTION OF SENATOR BROOKE

Mr. Stone, many insurance companies and even some of our witnesses at these hearings complain about the increasing number of different insurance policy forms prescribed in the various States and the burden this places on companies doing business in many States.

Do you think the Federal Insurance Commission might play a role in promoting standardized forms.

Response. There is, as you suggest, a proliferation of policy forms. In general, they are spawned by insurers who continually wish to develop and market new products. Seldom are they the creations of the state governments. The regulators' job, in most cases, is simply to examine and judge those forms presented to them for approval.

The complaints we sometimes hear concern state legal requirements as to language and content of forms for consumer protection purposes. It is a problem for companies to meet the varying content and readability standards of all states simultaneously. These problems can be expected to increase as more states adopt an active posture in this area. Although Massachusetts presently has no comprehensive statute which provides standards for the organization and language of policies, we are hopeful that one will be enacted this session.

I personally believe that a Federal Insurance Commission could be helpful in promulgating minimum standards for the content, organization and language of insurance policies throughout the country. Federal standards would ease the industry's problems with conflicting jurisdictions and, at the same, would lighten the burden on state Insurance Departments which must now duplicate policy review many times over. If the standards were well drafted, consumers would certainly gain. Now standardization of rules from state to state is currently the principal obstacle to the development of clear and readable policy forms.

**THE COMMONWEALTH OF MASSACHUSETTS,
DIVISION OF INSURANCE,**

Boston, Mass., September 19, 1977.

Mr. JEREMIAH BUCKLEY,

*Minority Staff Director, Committee on Banking, Housing and Urban Affairs,
U.S. Senate, Dirksen Senate Building, Washington, D.C.*

DEAR MR. BUCKLEY: Following the hearing on September 13, 1977, on Senate 1710, you asked me to elaborate on my evaluation of State Insurance Department examination capabilities in light of S.E.C. Commissioner Williams testimony about their uneven quality. Specifically, you asked me, "As a CPA, do you have confidence in the triennial examination process and the N.A.I.C. Convention statements which are not subject to independent audits?"

As you are aware, all insurers prepare an annual unaudited financial statement for filing with each State. These statements are periodically audited by State Insurance Departments. I am not aware of any State which audits more frequently than every three years, and certain States (including New York) perform them every five years or less frequently.

Prior to assuming my responsibilities for audits as Deputy Commissioner in 1975, I was an audit manager for a larger CPA firm and specialized in insurance

companies. In addition, I was responsible for several State audits where the firm was hired by other New England States to be their examining arm.

Based on my experience, the timing of audits is too infrequent. The constantly changing complexity of the insurance industry and the speed with which the financial impacts of new situations are reflected require at least annual financial audits.

It was this urgent need for annual audits that prompted Massachusetts to require all insurers doing business here to have an annual audit by an independent certified public accountant. This Rule was effective for 1976.

The best argument in support of this requirement was the successful rehabilitation of the Loyal Protective Life Insurance Company this summer. Loyal, a domestic Massachusetts Company, did not have independent auditors prior to this Rule. Ernst & Ernst, hired to comply with this Rule, discovered very early in 1977 that Loyal's December 31, 1976, reserves were seriously understated. As a direct result, we were able to prevent the insolvency of this company.

The problem of frequency of State examinations (3-5 years) is compounded by the length of time required to prepare and issue the audit report. Equity Funding's December 31, 1968, audit was not complete until April 30, 1970. Even then, it did not identify the company's problems. The last State audit of All-Star Insurance Co., referred to at the hearing, was for December 31, 1972, and was not complete until September 27, 1974.

A random sample of 25 reports in our files indicate that nearly two years (21 months) elapses between audit date and completion of the report. One insurer in the sample, Drake Insurance Company, required 54 months (12/31/71-7/15/76).

Finally, since the quality of State Insurance Examiners is uneven, it is not possible to fully rely on an examination report unless the auditors responsible are known to our Division.

I hope this is responsive to your question. I would be pleased to assist you further.

Very truly yours,

KEITH R. ROONEY, C.P.A.,
Deputy Commissioner of Insurance.

The CHAIRMAN. Senator Schmitt.

Senator SCHMITT. I would be happy to yield my time to the Senator from Massachusetts so he may proceed.

Senator BROOKE. No, I appreciate that from my esteemed colleague, but I will submit any further questions. I think the panel has been very helpful, an excellent panel. I think that you, Mr. Chairman, and Senator Schmitt both, have indicated that it is very helpful that we had this meeting with you to get your views on what is needed. I am very grateful to you.

The CHAIRMAN. Thank you very much, gentlemen, for your fine testimony. We very much appreciate it.

Our next witnesses are T. Lawrence Jones, president, American Insurance Association; Andre Maisonpierre, vice president, Alliance of American Insurers, and Arthur C. Mertz, president, National Association of Independent Insurers.

Gentlemen, we are happy to have you. You have some substantial statements here. We would appreciate it if all of you gentlemen could abbreviate your remarks as much as possible, in 10 minutes, if you can, so we will have time for questions. Your entire statements will be printed in full in the record.

Mr. JONES. Thank you, Mr. Chairman. Could I have Mr. Vinyard sit here with me?

The CHAIRMAN. By all means, Mr. Vinyard, won't you come up. If any of you other gentlemen would like to have someone with you, that is fine.

Mr. MURK. Mr. Chairman, in case you get too deep, I might want to call on my colleague sitting in the back.

The CHAIRMAN. All right, any way you want to handle it. Mr. Jones.

STATEMENT OF T. LAWRENCE JONES, PRESIDENT, AMERICAN INSURANCE ASSOCIATION, ACCOMPANIED BY WALTER D. VINYARD, JR., COUNSEL

Mr. JONES. My name is T. Lawrence Jones and I am president of the American Insurance Association, an organization of 145 insurance companies writing property and casualty insurance throughout this country. We are pleased to appear before this committee to present our views on S. 1710, introduced by Senator Brooke.

Title I of the bill creates a Federal insurance guaranty program similar to the Federal deposit insurance system available to banks. Title II provides a Federal chartering alternative which is similar conceptually to the alternative to banks and savings and loan associations.

TITLE I—FEDERAL INSURANCE GUARANTY

The Federal guaranty provisions of title I are not unfamiliar areas to the American Insurance Association. On November 19, 1969, we testified in favor of S. 2236, introduced in the first session of the 91st Congress by Senator Magnuson. That bill would have created a Federal Insurance Guaranty Corporation for the purpose of protecting the public against insurance company insolvencies. Applicable to all property-casualty insurers engaged in interstate commerce, the bill gained few supporters in the industry aside from American Insurance Association. It was vigorously opposed by most segments of the insurance business and the National Association of Insurance Commissioners. The active consideration of S. 2236 back in 1969, and conceivably AIA's support of the measure, led to the enactment of a model State post-insolvency assessment insurance guaranty law in many States.

Prior to the introduction of S. 2236, three States—Maryland, New Jersey, and New York—had prefunded insolvency laws. The workers' compensation laws of eight States had similar type security funds. In 1970, 19 States enacted the model postinsolvency assessment law, followed by 20 additional States in 1971. Currently, only Alabama and Oklahoma do not have some form of insolvency guaranty law.

All State laws and the District of Columbia law are now of the post-insolvency assessment variety with the exception of the New York law, which remains on a preinsolvency assessment basis.

Without denigrating the performance of State postinsolvency assessment laws, we agree with Senator Brooke's remarks on introducing S. 1710. It is true that these laws have yet to face the collapse of a major insurer with widespread interstate obligations. Such an unfortunate eventuality could place tremendous pressure on the present State-by-State system. Securing policyholders and claimants from losses resulting from an insurer insolvency through postinsolvency assessments has obvious weaknesses. Insurers cannot anticipate the cost of insolvencies and they can be exposed to assessment at time when all

or most insurers are suffering substantial losses. As an example, if GEICO had not been revived, assessments would have been imposed on insurers at one of the most critical periods for property-casualty insurers in recent years.

A glaring inequity of a postinsolvency assessment system is that only the healthy and well-managed companies contribute. Those that collapse through mismanagement or even fraud may never have contributed a penny to meet insolvency losses. A State preinsolvency assessment fund may be theoretically preferable, but again as Senator Brooke has pointed out, State security funds are subject to the whims of the legislature. Recently, the New York security fund was rendered illiquid just, in the words of Senator Brooke, "when it was most likely to be called upon to deal with an insurance company insolvency." Twice, moneys from the old New Jersey automobile preinsolvency assessment security fund were diverted into the New Jersey Unsatisfied Claims and Judgment Fund (chapter 241, laws of 1967 and chapter 822, laws of 1968).

American Insurance Association still supports the concept of a Federal insurance guaranty system. We believe a Federal system is the proper answer to possible insurance company insolvencies. Some form of Federal supervision would be a necessary adjunct to a Federal guarantee system but the supervision should be limited to what is essential to assure that the participating companies are financially sound and competently managed. In this respect S. 1710 grants broad regulatory power to the proposed Federal Insurance Commission, which in some areas is not clearly defined. Such pervasive, and to some extent uncertain, power bestowed upon the Federal regulatory body by S. 1710 is sure to feed fears that this bill is the beginning of the end of State regulation. Companies and State regulators will not be placated by the fact that not only is a Federal chapter optional but no company is required to seek a Federal guaranty certificate. Many believe that the choice is more apparent than real.

If most major insurers become part of the Federal guarantee system, the State postinsolvency assessment laws may no longer be viable, with the result that all insurers would be forced to apply for Federal guarantee certificates. With that "election" comes the distinct possibility that its financial operations, including its investment policy, will come under Federal control.

American Insurance Association continues to support the concept of a Federal insurance guarantee system, but we are concerned with the extensive Federal regulation contained in S. 1710. We believe a Federal guarantee system can be achieved without establishing a large Federal supervisory body and without providing a very broad and comprehensive pattern of control covering all aspects of financial management.

TITLE II—FEDERAL CHARTERING OF INSURANCE COMPANIES

The unusual, and unique for the insurance industry, part of the bill is title II, providing a Federal chartering alternative. Many segments of the business will be opposed to title II for a variety of reasons, but it may have an attraction for some companies. It will appeal to some

property-casualty insurers which may conclude that the States will continue to vacillate on competitive rating laws, ignoring the views of the Department of Justice and regulatory scholars that price competition is the best way to maintain reasonable premium levels.

Other insurers, perhaps few in number at the present time, may become concerned with the increasing diversity of regulation by the 50 States and the District of Columbia. Each jurisdiction tends to go off on its own oblivious to the regulatory demands of other States. This is a far cry from the post-SEUA decision and McCarran-Ferguson Act (effective March 5, 1945) period. Then the States, fighting to preserve State regulation, acted in unison with an awareness that a business which had just been held to be a part of interstate commerce could not be regulated effectively and in the public interest if each State went its separate way. But that good beginning has not been maintained. The hard fact is the only important model uniform bill to be enacted extensively by the States in the past 30 years has been the model State Post-Insolvency Assessment Guaranty Association Act, sponsored by the National Association of Insurance Commissioners. In other important areas, the pattern of regulation, in terms of reasonable uniformity, is disappointing.

On the other hand, one of the principal advantages of State regulation is the opportunity for States to adjust their regulatory philosophy to local needs. This is important and should not be ignored. However, in our judgment, State regulation would be greatly improved if more attention were paid to the essentially interstate nature of the business and the need to achieve comity and cooperation among the States.

Without discussing the details of title II, we would like to offer some general comments. Section 204(a)(4) of title II exempts federally chartered insurers from State rate regulatory laws with two exceptions, one of which is particularly important. Section 109(c) of title I provides that the Federal antitrust laws shall be applicable to federally chartered insurers "with respect to those activities that are exempt from certain State regulation as specified in section 704 of this act."

This is aimed at property-casualty insurers which in the past, and still in varying degree, have pooled experience either for cooperatively developed rates or to assist companies in making their own individual rates. No such collective activity relating to rates is utilized in the life insurance business, because of the nature of the business. Thus, no adjustment for life insurers which elect to seek a Federal charter has to be made. Aside from the area of advertising, there are no important areas where life insurers are regulated by State law pursuant to the McCarran-Ferguson Act in order that the Federal antitrust laws not apply. On the other hand, most property-casualty insurers opting for Federal charters would have to make many adjustments if they were to become fully exposed to the Federal antitrust laws. Some of the problems for property-casualty insurers are discussed in detail in a report of the Department of Justice to the Task Group on Antitrust Immunities entitled, "The Pricing and Marketing of Insurance" (January 1977).

Not too many years ago the very idea of operating under the Federal antitrust laws would have been considered wholly unrealistic by most

segments of the property-casualty insurance business. Too much of the business was written at bureau rates and an instant leap into free price competition would not have been feasible. Today's marketplace is quite different from the period following the SEUA decision and enactment of the McCarran-Ferguson Act. Healthy price competition prevails in most major lines and throughout the country where permitted by State law. Unfortunately, a number of States have been laggard in revising their rating laws to adapt to a totally different marketplace.

Our member companies support the enactment of competitive rating laws. We agree with the Antitrust Division of the Department of Justice that such State rating laws serve the public much more effectively than laws requiring approval of rates. There is no justification for requiring competitive prices to be approved before they are put into effect. States which are still trying to require prior approval of competitive rates are encountering all kinds of difficulties; the availability of insurance is becoming a major problem.

It should be made abundantly clear that the State competitive rating laws advocated by American Insurance Association do not merely eliminate prior approval of rates. They specifically prohibit agreements to adhere to rates and contain other antitrust proscriptions similar to the Federal laws.

The point we wish to make is that today there is much less reliance on bureau-developed rates. Thus, the transition to a completely free and unregulated market, subject only to Federal antitrust constraints, does not present the same kind of transitional obstacles which existed in the past, for the simple reason that the posture of the marketplace has changed radically. Of course, there will be difficult areas requiring special attention. One of the major unresolved problems is the treatment of residual markets, which include the various facilities for providing insurance to risks which are unable to obtain coverage in the voluntary market. Examples are the automobile assigned risk plans, the FAIR plans for property insurance, windstorm pools, and joint underwriting associations for medical malpractice insurance.

Under S. 1710 a federally chartered insurer is exempt from any State law regulating and fixing rates except laws regulating residual market rates (section 204(a)(4)). This means that voluntary market rates will not be regulated by the State but will be subject to the Federal antitrust laws. On the other hand, residual market rates will still remain subject to applicable State law. Many believe it is difficult to have competitive pricing in the voluntary market when rates in the involuntary market remain under tight State control. This dilemma exists today in competitive rating law States and it would continue to plague free price competition for federally chartered insurers under S. 1710.

AIA POSITION

It is difficult to oppose any legislative proposal which is intended to be optional. On its face S. 1710 does not require an insurer to seek a Federal charter nor does it require any company to apply for a Federal guaranty certification. But as we have indicated, we believe that once some major companies have obtained Federal guaranty certification, virtually all companies will be forced to follow the same route. They

may even have to go the whole way and seek Federal charters because some of their principal competitors, having obtained Federal charters, are no longer subject to the pricing burdens or the delays inherent in cumbersome State prior approval rating laws.

If in fact there is no real world choice, S. 1710 presents us with what in substance is not unlike a complete Federal preemption of insurance regulation. Since American Insurance Association continues to support State regulation, we cannot endorse S. 1710.

We realize that others may differ with our interpretation and believe that S. 1710 will not result in Federal preemption. Others may favor S. 1710 or the concept of a Federal chartering alternative regardless of any long-term implications for State supervision of the insurance business.

S. 1710 needs a great deal more study, and not just its own specific provisions. Some areas of inquiry might cover:

First. Are there other national systems for handling insolvencies beyond that envisaged by S. 1710?

Second. Should the matter of insolvency, Federal chartering, and competitive pricing be approached separately or in one bill as suggested by S. 1710?

Third. Is it possible to have a dual system, as contemplated by S. 1710, or will the Federal alternative inevitably replace State regulation? Assuming the former, how will the dual system work?

These are just some areas of inquiry that come to mind.

We thank you for the opportunity to present our views today.

The CHAIRMAN. Thank you, Mr. Jones.

Mr. Maisonnier, you have a 40-page statement. I presume you are not going to read it in full. It is a fine statement, we will be happy to print it in the record. Could you give it to us in about 8 or 9 minutes?

Mr. MAISONPIERRE. Yes, sir.

STATEMENT OF ANDRE MAISONPIERRE, ON BEHALF OF THE ALLIANCE OF AMERICAN INSURERS

Mr. MAISONPIERRE. We appreciate the opportunity to testify on S. 1710, the Federal Insurance Act of 1977.

Our statement describes the advantages which would accrue to companies electing to become federally chartered or opting for participation in the proposed Federal guarantee fund. It also describes the disadvantages which would befall those companies electing to come within the Federal orbit. More importantly, our statement examines, in detail, the profound changes which the enactment of this bill would produce in the operation of the property and casualty insurance system. We believe that the total fabric of insurance regulation would be radically realigned if this legislation were to be enacted and that a substantial impact would be felt by companies electing not to participate in this Federal program.

Enactment of this bill would directly impair the ability of small companies to price their insurance product; it would limit the ability of the insurance industry to establish commercial pooling agreements through which essential underwriting capacity can be created to insure certain exposures; it would likely bring to an end the existing

State insolvency mechanism; and, finally, it will require the creation of a massive new Federal bureaucracy.

These issues will now be discussed in turn:

A. The legislation will substantially hamper the ability of small companies to price their product.—The McCarran-Ferguson Act, recognizing the need to pool certain information to develop rates and premiums granted broad immunities to the insurance industry from Federal antitrust laws. The smaller an insurance company, and the more limited its market penetration, the more dependent that company is on aggregating its experience with that of other carriers. Today, the aggregation and trending of experience is done through rating and statistical bureaus.

It is questionable whether federally chartered companies, no longer immune from Federal antitrust laws, would be legally capable of participation in bureau activities. Furthermore, since it is assumed that federally chartered companies will operate in a "free market economy," they would be inclined to develop their own individual and unique rating classes, territories and rating plans peculiar to their own operations. The aggregation by bureaus—even if allowed—of such widely varying systems will produce an amalgam of information which many individual companies will find of little use in the development of their own individual rates.

Absent regulation and absent restriction on diversity of classification plan, it is questionable whether large insurers under the Federal Insurance Act would continue to support bureau operations. Where, then, will this leave the smaller insurance companies? One should certainly expect that this will have major impact on the competitive nature of the insurance business and that substantially increased territorial market concentration will follow.

B. The legislation will undermine the stability of workers' compensation insurance.—A particularly troublesome situation will arise in the area of workers' compensation insurance. We believe that because federally chartered companies would be legally prohibited from participating in bureau operations the present workers' compensation rating system would be substantially dismantled. Yet, workers' compensation insurance represents unusual actuarial difficulties in achieving accurate rates in part because of the limitless benefits, both as to time and amount provided, under this coverage. Further, long delayed reactions to occupational exposures to harmful substances create major difficulties in assessing an insurance carrier's liability at any one time.

Because of the overriding social purpose of the workers' compensation system, the States are even more concerned about market stability for this line of insurance than for most others.

There is no doubt that to the extent that insurers do become federally chartered the stability of the workers' compensation system will be very similar to the troubles that have been recently highlighted in product liability and malpractice insurance.

C. The legislation will reduce the ability of companies to meet consumer insurance needs through pooling agreements.—In order to provide the capacity necessary to respond to the insurance buying public's needs, insurance companies have established numerous pooling devices. At times, it is only through such pools that sufficient insurance

capacity can be created to insure certain exposures. At other times, such pools provide the opportunity for greater market competition among insurers by allowing smaller insurers to pool their capacity with others to enable them to bid on an exposure which only larger companies can otherwise afford to do.

If such pooling devices were not permitted, or common rates and forms not permitted, many large risks would find it difficult if not impossible to secure adequate insurance coverage. This of course would be to the detriment of the insurance buying public.

Federally chartered companies, no longer protected by McCarran-Ferguson antitrust immunities, would likely abandon their participation in such pooling mechanisms. At least, until the legality has been established.

Yet, these are important industry practices. The fact that conflicts with antitrust laws exist do not, obviously, make these practices undesirable from a consumer's standpoint. Many of these practices were created to make insurance available to broader publics in a more competitive environment. But, the courts have not always held that a clear public interest is of itself sufficient to overcome a legal barrier.

D. The Federal Insurance Act will substantially weaken consumer protection against losses resulting from company insolvency.—S. 1710 would establish a Federal insolvency system to compete with the presently existing state insolvency programs. However, S. 1710 makes no attempt to compete fairly with the State system. It allows participation in the Federal program only for those companies which meet that degree of financial stability promulgated by regulation by the Federal Insurance Commission. One must assume that the degree of stability which will be required by those regulations will be substantial. Hence, only the stronger insurance institutions will be allowed to participate in the Federal guarantee plan. If the State plans were to apply the same selectivity the public would receive little or no protection against company insolvencies since those companies more likely to become insolvent would be excluded from both the Federal and the State system.

To the extent that the strongest financial companies elect to participate in the Federal program, it will then fall upon the weaker companies to attempt to respond to the losses generated from insolvencies through State guarantee fund postassessments. It stands to reason that the State insolvency system would collapse in time.

An additional grossly unfair competitive advantage is provided the federal system because the legislation puts roadblocks in the way of companies desiring to leave the federal system, but makes it very easy for a company to enter the federal system. Is it not reasonable to expect that once a company finds that a competitor may be in serious financial difficulty, and that upon the insolvency of that competitor it would be called upon for a substantial assessment in case that insolvency materializes, that it would seek immediate participation in the Federal guarantee program in order to escape the postassessment levy? Thus, companies would be invited to avoid their obligations under State insolvency plans.

E. The bill calls for the establishment of a vast new Federal bureaucracy.—The proposed responsibilities and powers of the Fed-

eral Insurance Commission specified in S. 1710, are both extensive and concentrated. Our statement reviews them in some detail. They parallel in part the oversight responsibilities of both the FDIC and the Comptroller of the Currency. The Federal Insurance Commission would also include, of course, all the programs and responsibilities of the Federal Insurance Administration now in the Department of Housing and Urban Development.

Given the extent of its power and the political pressures which would undoubtedly affect the Commission, it is quite probable that the Commission would be prodded to expand its regulatory role well beyond solvency issues to involve most if not all aspects of insurance company management. To demonstrate this point, just consider the nature of the actual powers proposed for the Commission. These powers must be viewed in the context and the environment in which they would be employed. Policyholders, consumer groups and others have increasingly been seeking political solutions to insurance problems, not only at the State level but in Washington, as well. And it is under this environment of complex and increasing political pressures that the Commission would exercise its powers.

One can estimate the potential size of the Federal Insurance Commission by comparing it to the FDIC, after which it was patterned in part, the Federal Insurance Administration which it would absorb and the Comptroller of the Currency function which conducts parallel and extensive examinations of federally chartered banks. It is not improbable that a Federal Insurance Commission once fully operational would employ several thousand employees both in Washington and the field with an operating budget that could easily exceed \$100 million.

To what extent would duplicate and/or parallel State and Federal regulatory system require an increase in paperwork? The overlap would be extensive for those companies with State charters who join the Federal guarantee program.

But, the overlap does not stop with those companies. Section 107 (b) of the bill authorizes the Federal Insurance Commission to establish "an early warning system." Further, it states that "In order to render possible comparison and thus make available broad financial and statistical data, any such 'early warning system' may include both federally guaranteed insurers and other insurers." The phrase "and other insurers" clearly gives the Federal Insurance Commission the authority to require reports, data, et cetera from all insurers even though they may be State chartered and do not participate in the Federal guarantee fund.

The goals of insurance regulation were stated in 1960 by the NAAIC to be:

First. That insurance coverages desired by the public should be generally available to the public from licensed insurers;

Second. The cost of such insurance coverages to the public should be reasonable and not excessive;

Third. That the solvency of insurers should be maintained in the interest and for the continued protection of their policyholders;

Fourth. That each insured should bear his fair share of insurance cost.

The means of achieving these goals, however, are necessarily complex. While each of these objectives are not necessarily mutually exclusive, they do conflict, to some degree.

The true measure of the efficiency of insurance regulation is not how well each of the above-mentioned objectives is achieved, but how well they are balanced in the actual world.

It is obvious that to achieve good, balanced insurance regulation the responsibility for achieving the regulatory ends cannot be "split between competing sovereigns."

Yet, this is exactly what S. 1710 would do. It would create, within the Federal Establishment, a Federal Government authority which will compete and share with State government the responsibility to regulate the insurance business.

S. 1710 goes considerably beyond its stated objectives. It will ultimately totally realign and unsettle the competitive structure of the insurance business, leading to considerably greater territorial market concentration than exists today. The effect will be less competition, less service, and less public protection. It will also lead to more regulation, more litigation, greater uncertainty, and certainly more paper work.

S. 1710 would bring into being, extensive regulatory changes seriously disrupting the operation of the existing State insolvency protection mechanism.

Additionally, the legislation will undermine the security market for publicly held companies, while insurance investments may well become highly concentrated in only the highest quality blue chip investments.

Finally, S. 1710 will require the establishment of a vast new Federal bureaucracy at a time when the President, Congress, businessmen, and the electorate have made it clear again and again that what this country requires is less regulation and a contraction of existing Federal regulatory agencies.

[Complete statement of Mr. Maisonnier follows:]

**DUAL AND CONCURRENT
REGULATION OF INSURANCE**

STATEMENT OF THE

ALLIANCE OF AMERICAN INSURERS

before the

SENATE COMMITTEE ON BANKING HOUSING AND URBAN AFFAIRS

ON

S. 1710

THE FEDERAL INSURANCE ACT OF 1977

SEPTEMBER 13, 1977



HIGHLIGHTS OF ALLIANCE STATEMENT

The Alliance is convinced that dual regulation of insurance would be unwieldy and duplicative while also breeding competition among regulators that would lead to increased economic regulation. (pages 3-12)

The bill (S.1710) would:

...undermine the security's market for publicly held insurance companies, while investments for all insurance companies may well become highly concentrated in only the highest quality blue chip investments. (pages 9-10 & 32-33)

...substantially hamper the ability of small companies to price their product (pages 13-16)

...undermine the stability of state workers' compensation insurance. (pages 16-18)

...reduce the ability of companies to meet consumer insurance needs through pooling arrangements. (pages 18-20)

...substantially weaken consumer protection against losses resulting from company insolvency. (pages 20-27)

...require the creation of a vast new federal bureaucracy which will compete with existing federal regulatory programs. (pages 27-37)

The goals of insurance regulation seek to maintain a viable insurance market in which consumers may secure their insurance needs at reasonable costs in a competitive environment. It is obvious to the Alliance that to achieve good, balanced insurance regulation, the responsibility for achieving the regulatory ends cannot be "split between competing sovereigns." (pages 38-40)

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My name is Andre Maisonnier. I am a vice president of the Alliance of American Insurers (formerly the American Mutual Insurance Alliance). The Alliance is one of the major national associations of property and casualty insurance companies. Its member companies write property and casualty insurance in all states and the District of Columbia.

I. INTRODUCTION

We appreciate the opportunity to testify on S. 1710, the Federal Insurance Act of 1977. Conceptually, the stated purposes of S. 1710 are to create a "dual system" for the regulation of insurance companies which:

1. Permit federal chartering;
2. Provides for financial regulation including insurance reserves, investments, underwriting capacity and solidity;
3. Frees federal chartered companies from state retaliatory taxes;
4. Exempts federally chartered companies from state regulation of rates except in the residual market area; and,
5. Creates a federal insolvency guarantee mechanism.

Thus, the bill poses important issues with respect to the desirability of federally chartered insurance companies; pricing considerations under the federal antitrust laws; federal regulation of insurance; and the creating of a federal guarantee fund mechanism. The bill, in many respects, is not as comprehensive as

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comparable state insurance codes. Nevertheless, certain conclusions can be drawn concerning the effect of the legislation. Certainly, its potential impact, in creating two competing regulatory systems, raises a host of unanswered questions concerning its effect in major areas.

II. COMMENTARY ON S. 1710

A. Advantages Conferred On Companies Electing Either A Federal Charter Or Participation In Federal Insurance Mechanism

The bill ostensibly does confer certain clear benefits to individual insurance companies electing a federal charter:

1. A federal chartering option does provide an opportunity for escape to those companies which believe they are being oppressed in their states of domicile by certain laws or regulations applicable to domestic companies only. This is particularly true as regards state tax statutes which can place a heavier burden on domestic companies.
2. The bill does allow federally chartered insurance companies to escape politically inspired state rate regulation.
3. The bill also provides a specific escape for federally chartered companies from state retaliatory taxes.

There is another aspect of the proposed legislation which will accrue to federally chartered companies, but this is also available to state chartered companies who become members of the Federal Guarantee Fund. S. 1710 relieves these companies who join the federal guarantee fund from continued participation in state insolvency programs and concomitant insolvency assessments by the state funds.

Nevertheless we are convinced that the contemplated concept of dual regulation of insurance would be unwieldy and duplicative and that it would breed competition among regulators that would lead to increased economic regulation. To place this issue in perspective,

one should keep in mind that in its recent report on Insurance Marketing and Pricing (1976) the Justice Department called for less economic regulation and more open competition in insurance markets. We echo the views expressed by Robert Hunter, the recent Acting Federal Insurance Administrator that "the public is best served by an insurance system under which private enterprise remains the principal provider, and the states, the regulators of insurance. This time, honored position is philosophically sound, but requires innovative approaches to assure its continued success over the congressional voices espousing federal takeover." In a speech to the Independent Insurance Agents of Wisconsin (5/6/76), Mr. Hunter said further, "I yield to no one in the belief that the insurance industry should remain in private hands under state regulation... I stress the Federal Insurance Administration's position that a state regulated system of privately provided insurance can best serve the needs of all Americans. I view with great concern the apparent disposition on the part of many in Congress to propose federal solutions to the real insurance problems of today... It is important for those...of us in Government to take the lead in explaining why a state regulated private system works best."

B. Disadvantages Imposed On Companies Electing Either A Federal Charter Or Participation In Federal Insurance Mechanism

It must be well understood, that federally chartered and state chartered companies who are members of the Federal Guarantee

Fund would pay a price for these potential aforementioned benefits. Furthermore, a substantial impact would be felt by companies electing not to participate in the federal insolvency program. In fact, the total fabric of insurance regulation would be radically realigned if this legislation were to be enacted.

While the bill has been described as providing a "federal chartering alternative" for insurance companies, it is apparent that the overall effect of the legislation is to bring about "dual" regulation. This is particularly true in the area of potential discrimination based on age, sex, marital status, etc. It would also subject state chartered companies participating in the federal insolvency plan to concurrent federal and state financial examinations. Dual regulation would also lead to increased economic regulation in regards to insurance investments and reserving practices.

Finally, with state insurance departments responsible for residual market insurance programs and the proposed Federal Insurance Commission actively involved with insurance availability matters, it seems certain that confusion will prevail and the insurance consumer may well end up the ultimate loser.

This concern about the effect of a dual regulatory system was proposed by the Acting Federal Insurance Administrator in a comment to the Justice Department; relative to the Antitrust Division Report on Insurance Marketing and Pricing:

"Dual regulatory authority, split between competing sovereigns...would be regarded as the worst of all worlds by all parties concerned, state regulators, insurers, and the insured public. This dichotomy would be even worse than that normally encountered where authority is, and appears to be, divided between state and federal authority...It would breed, in fact, the very kind of controversy which is currently raging between state insurance regulatory authorities and the federal regulatory authorities over the Pension Reform Act (ERISA)...The outcome of the controversy is not predictable, but what is easily predictable is that it will breed a lot of law suits."

State insurance departments would continue to regulate federally chartered companies to the extent not specifically preempted by this federal bill even though a federally chartered company under this law is authorized to do business in any state. Without attempting an exhaustive list, federally chartered property and casualty insurers will be subject to state regulatory laws pertaining to policy forms, cancellation and underwriting requirements and standards, agency forces, fees, counter-signature, and unfair trade practices. However, while those companies will be subject to these state laws, state regulatory authorities would have no enforcement power over them except through the Federal Insurance Commission.

The bill would establish concurrent jurisdiction with respect to federally guaranteed insurers (federally chartered companies and state chartered companies which are members of the federal guarantee fund) in the area of discrimination based on age, sex, race, religion or national origin.

Once federally chartered, a company's return to state chartering would be theoretically possible under S. 1710 but by no means easily accomplished. An insurer may relinquish its federal charter only pursuant to a vote of a majority of all its stock holders or policyholders (not just a majority of those voting) and must include a notification to all policyholders of loss of guarantee fund status. The company would then have to apply for a certificate of authority in those states in which it wanted to continue to do business, a time consuming process. Similarly, a state chartered company which was a member of the federal guarantee fund could only relinquish its membership in such guarantee fund upon notification to all policyholders of loss of guarantee fund status.

The significance of the foregoing is apparent in view of the often repeated representation that in analogous situations, banks are allowed to slip from federal to state charters and return with considerable ease and that this has proved or could prove to be advantageous to individual banks. It is believed that this representation does not reflect the actual situation under banking laws. True, banks may be either federally or state chartered. Few banks actually move back and forth between federal and state charter however.

Most state chartered banks have, elected to become insured under the Federal Deposit Insurance Corporation while there is no such corollary institution at the state level. Also, both federally chartered banks and state banks who are members of the FDIC are regulated as to their financial solidity by an arm of the federal government. It is believed that it is the ability of banks to maneuver within a complex federally dominated regulatory environment which is so often confused as an ability to move in and out of state or federal control.

Under the proposed legislation, the capital and surplus requirements needed by an insurance company to become federally chartered will be set, by rule, by the proposed Federal Insurance Commission. There is no indication whether such requirements will be high or low in relation to present state requirements or will differ by insurer, by the type of insurance or line written by that insurer, or by geographical area in which such business is written.

Federally chartered companies are exempt from state regulation with regard to rates and classification. It is not known whether the states might still retain prior approval or power of rating territories and rating plans, however. While state rate regulation is prohibited, adoption of this legislation would not foreclose, of course, future Congresses from controlling insurance rates.

It should be noted that control of rates in the residual insurance market is left to the states. This may be an invitation to state regulators to manipulate assigned risk rates so as to exercise defacto control over voluntary market rates. For example, New York and New Jersey are subsidizing assigned risk automobile rates by artificially depressing the insurance rates for this category. While it is impossible to determine the effect of S. 1710 in this area, the opportunity for rate manipulation by the states is open to question.

The treatment of taxation under the Federal Insurance Act gives cause for considerable concern. If larger insurance companies and/or significant segments of premium volume elect federal chartering, the states could certainly increase the level of taxation substantially for all remaining companies. This is particularly so where states might no longer find it necessary to protect domestic companies from retaliatory action by other states.

We also are concerned with the provision which would allow the Federal Insurance Commission to disallow any specific investment upon finding that "such investment does not meet the standard of unquestioned integrity and stability." We believe that this provision provides the Commission with awesome power over a company's investment portfolio. It would appear to give the Commission authority over specified portfolio items and could significantly increase the concentration of invested insurance assets

in only the biggest and financially the soundest of domestic business. At the same time it could cut off sources of capital to smaller companies and significantly affect the financing of real estate developments. Such a possibility is very real. One has only to review how pension trust managers reacted when investment criteria were established under ERISA. At present, the property, casualty and life insurance companies in the United States have in excess of \$400-billion in assets. This has been an important source of venture capital in the economy.

We submit that the establishment of a preassessment insolvency fund -- the federal insurance guarantee program -- is likely to bring to an end existing state insolvency programs, at least if there is any significant move of companies to the federal level. One may well expect that the larger and more stable insurers would be the first to move to the federal ranks, resulting in the smaller less financially stable to be left behind; in effect creating adverse selection at the state level. Additionally, the simple reduction in the number of insurers on the state insurance system will impose too heavy a burden on those left behind. Whatever the causes, we do not believe that two such competing insolvency reimbursements systems can long endure concurrently.

Finally, the establishment of a Federal Insurance Commission as an independent agency in the executive branch of the federal government creates direct federal involvement in insurance regulation. Apart from minimal Federal Trade Commission jurisdiction over mail-

order insurance and mergers, and regulation by the Securities and Exchange Commission over publicly held insurance companies, there has never been direct federal financial regulation of insurance. The Federal Insurance Act of 1977, however, provides for dual and concurrent financial regulation of federally chartered companies and state chartered companies who are members of the federal guarantee fund.

Senator Brooke has indicated that his bill would seek to improve the quality of insurance company regulation by providing for an alternative system similar to the Federal regulatory alternative presently available to banks and savings and loan associations under what has come to be known as the dual banking system. Since this legislation is intended to structure a Federal insurance regulatory system patterned in part after existing Federal bank regulatory mechanisms it would be instructive to briefly review how well the bank regulatory system has performed. Consider:

At present there are three organizations which exercise regulatory authority at the federal level, the Federal Reserve Board which supervises member banks, the Federal Deposit Insurance Corporation, which insures bank deposits and the Comptroller of the Currency who examines national and D.C. banks. There has been increasing concern voiced that these organizations compete to some extent in their regulatory responsibilities for banks under their respective jurisdictions. There exists today bank examiners in the various

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states who also exercise regulatory responsibilities. In summary, the bank regulatory system exhibits overlapping and duplicative regulatory authorities and is itself the subject of hearings for reorganization at the federal level.

Despite the existence of extensive Federal regulatory programs banks continue to fail and the increasing number of bank failures in the past few years plus the number of problem banks is a source of genuine concern. In fact, the existence of National Early Warning Systems has not prevented several large bank failures in recent years.

It is not any more realistic to expect federal state co-operation in regulating insurance companies than it is for bank regulators to work closely together at the federal and state level.

It is abundantly clear that enactment of this bill would produce major changes in the operation of the property and casualty insurance system. For instance, it would directly impair the ability of small companies to price their insurance product; it would limit the ability of the insurance industry to establish commercial pooling agreements through which essential underwriting capacity can be created to insure certain exposures; it will, as already mentioned, likely bring to an end the existing state insolvency mechanism; and, finally, it will require the creation of a massive new federal bureaucracy and lead to a period of instability, uncertainty, litigation and increased economic regulation.

III. DISCUSSION OF PRIMARY ISSUES RAISED IN 2.1710

These issues will be discussed in turn:

A. The Legislation Will Substantially Hinder the Ability of Small Companies to Price Their Product

The McCarran-Ferguson Act, recognizing the need to pool certain information to develop rates and premiums granted broad immunities to the insurance industry from federal anti-trust laws. The smaller insurance company, and the more limited its market penetration, the more dependent that company is on aggregating its experience with that of other carriers. Smaller property casualty insurance companies just do not have an adequate loss experience of their own to develop credible information upon which to base their insurance rates by product line.

Out of 2882 property and liability insurance companies licensed in the United States in 1976, 900 operated in most states and wrote the vast majority of business. Many life insurance companies, particularly, the new ones, are also relatively small when compared to older well established life insurers. In other words - most insurance companies are relatively small, have limited product lines and offer their services in finite market areas.

In commenting on the Anti-Trust Division Report on Insurance Pricing and Marketing, the FIA stated that "smaller companies could not possibly make their own rates based only on their own loss experience simply because such experience (by itself) would be entirely lacking in credibility."

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Today, individual insurance company loss experiences is pooled with other carriers through rating and statistical bureaus. This combined experience is then treaded so that past loss experience can be utilized to estimate future loss experience. Bureaus will publish advisory rates which the member companies may use in the development of their own rates. It is absolutely essential that the raw experience data acquired by these rating bureaus are representative of the total exposure being insured and that the data provided by member companies can be properly assimilated. Hence, companies must report their losses to bureaus using relatively similar rating and territorial classification systems to allow for the necessary aggregation of information.

However, the utilization of rating bureaus is open to question under the Federal Insurance Act. Note that companies that elect to become federally chartered will no longer be immune from federal anti-trust laws. It is questionable whether federally chartered companies would be legally capable of exchanging any price information, including information limited to losses incurred. It is clear, however, that federally chartered companies would be prohibited from membership in a rating bureau which trends past losses to enable its members to price their insurance products. Furthermore, since it is assumed that federally chartered companies will operate in a "free market economy", they would be inclined to develop their own individual and unique rating classes, territories and rating plans peculiar to their own operations. The aggregation by bureaus -- even if allowed --

of such widely varying systems will produce an amalgam of information which many individual companies will find of little use in the development of their own individual rates.

Again, citing the comment from the Federal Insurance Administration to the Justice Department, the FIA said "one of the obvious problems in respect to permitting the existence of a wide variety of elaborate and incompatible class plans under an open rating concept is that the millions of potential rating slots thereby engendered may negate credibility for the loss experience of many or most of the individual classes and may preclude the making of proper relativity tests."

What is likely to happen is that the larger companies will no longer support bureau operations. First, they will be deterred from any bureau operation activities until these have been legally established. Second, the larger companies will question their continued support of bureau operations particularly if they perceive that their limited operations will be of little help to them but will primarily benefit competitors.

Accordingly, absent regulation and absent restriction on diversity of classification plan, it is questionable whether large insurers under the Federal Insurance Act would continue to support bureau operations. Where will this leave the smaller insurance companies? One should certainly expect that this will have major impact on the competitive nature of the insurance business and that substantially increased territorial market concentration will follow.

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It is interesting to note that Congressional critics of the insurance industry have urged insurers and state regulators to establish the development of data collection systems which will allow for more precise consideration of public policy alternatives and issues. Federal chartering of insurance companies would, without question, prevent the implementation of improved insurance data banks.

B. The Legislation Will Undermine the Stability of Workers' Compensation Insurance

A particularly troublesome situation will arise in the area of workers' compensation insurance. We believe that because federally chartered companies would be legally prohibited from participating in bureau operations the present workers' compensation rating system would be substantially dismantled. This system relies upon highly refined classification plans, and the adoption by all member companies of the rating bureau of uniform experience reporting and retrospective rating plans, including expenses. Obviously, under the Federal Insurance Act, anti-trust considerations would preclude such operations. Yet, workers' compensation insurance represents unusual actuarial difficulties in achieving accurate rates in part because of the limitless benefits, both as to time and amount provided, under this coverage. Most state workers' compensation laws require the payments of lifetime benefits to widows and to those permanently injured. Additionally, most laws provide for unlimited medical benefits, both as to time and amount, to be paid injured workmen. Further, long delayed

reactions to occupational exposures to harmful substances create major difficulties in assessing an insurance carrier's liability at any one time.

Workers' Compensation is a form of social insurance, required by all states. One of its main purposes is to encourage employers to reduce job hazards through the use of positive incentives, loss prevention and education. The rating system used in workers' compensation does this by means of a highly refined classification system which allocates the cost of work accidents to each industry and to each individual employer within the industries to a much greater extent than is considered economically feasible or necessary in other lines of insurance. The extreme range of job related hazards covered by workers' compensation insurance are reflected by a rate differential which at the bottom of the scale might call for a premium rate of \$.10 per \$100 of payroll and at the top of the scale \$50.00 or more per \$100 of payroll. This range covering hundreds of job classifications makes it impossible for one single insurer to establish credible rates on the basis of its own experience.

We hasten to add that this condition by no means precludes competition among insurance companies providing workers' compensation insurance. There is both price competition and service competition. Price competition is reflected through retrospective rating plans and through sliding scale dividend participation plans which are used today by most large companies providing workers' compensation insurance.

Competition in service by insurers is also channeled into socially desirable ends including loss prevention, promptness of payments and rehabilitation activities. In fact, legislatures and regulators have chosen to provide through the workers' compensation insurance rating system direct incentives for employers to compete with each other in reducing job hazards.

Furthermore, in part because of the refined classification system, and in part because of the overriding social purpose of the workers' compensation system, the states are even more concerned about inadequate rates for this line of insurance than for most others. Under state workers' compensation laws, an injured worker may be entitled to benefits extending outward in time for forty years or longer. Having specified by law what benefits an injured worker is entitled to receive, the state has a strong interest in seeing that insurance carriers paying those benefits will remain solvent and be able to fulfill their obligations.

There is no doubt that to the extent that insurers do become federally chartered the stability of the workers' compensation system will become severely disrupted. The impact on the market place will be very similar to the troubles that have been recently highlighted in product liability and malpractice insurance. We are convinced that this would not be in the best interests of either injured workers or the business community.

C. The Legislation Will Reduce the Ability of Companies to Meet Consumer Insurance Needs Through Pooling Agreements

In order to provide the capacity necessary to respond to the insurance buying public's needs insurance companies have established

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numerous pooling devices such as, aircraft insurance pools, factory mutuals, nuclear pools, oil pools, fluid industry pools, etc. At times, it is only through such pools that sufficient insurance capacity can be created to insure certain exposures. At other times, such pools provide the opportunity for greater market competition among insurers by allowing smaller insurers to pool their capacity with others to enable them to bid on an exposure which only larger companies can otherwise afford to do. In many of these pools a common rate is used and charged the purchaser of insurance. Additionally, on large commercial risks, insurance brokers routinely get many different insurers to accept a portion of the risk at a common rate and on a common form. In all such situations all insurers in the pool must agree on what the price for a particular risk should be. If such pooling devices were not permitted, or common rates and forms not permitted, many large risks would find it difficult if not impossible to secure adequate insurance coverage. All this of course would be to the detriment of the insurance buying public.

Federally chartered companies, no longer protected by McCarran-Ferguson antitrust immunities would likely abandon their participation in such pooling mechanisms. We recognize that the Report on Insurance Regulation (The Pricing and Marketing of Insurance) published by the Antitrust Division of the Justice Department in 1976 suggests that the Federal antitrust laws would not necessarily prohibit pooling mechanisms and arrangements essential for making available broad insurance markets. And, while we agree with the Report that a good case could and would be made that such commercial

arrangements substantially enhance competition, it will be for the courts to decide the legality of such practices. Until such court decisions are final, the status of commercial insurance pooling arrangements will remain in doubt. Unquestionably, executives of federally chartered companies will be deterred from continued participation in such plans until their legality has been established.

These are important industry practices. Yet serious conflicts with federal antitrust laws would force federally chartered companies to abstain from participating in such programs. The fact that conflicts with such laws exist do not, obviously, make these practices undesirable from a consumer's standpoint. Many of these practices were created to make insurance available to broader publics in a more competitive environment. But, the courts have not always held that a clear public interest is of itself sufficient to overcome a legal barrier.

While some of the existing pools are composed of smaller companies -- companies which at least initially would not elect to become federally chartered, some other pools are very dependent on participation by some of the industry's major insurers. To the extent that those insurers become federally chartered, it is questionable whether such pools could continue to exist without their essential participation.

D. The Federal Insurance Act Will Substantially Weaken Consumer Protection Against Losses Resulting From Company Insolvency

In his introductory statement accompanying S. 1710, Senator Brooke stated that "the trauma of the last few years has brought home

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to me the need to improve the protections available to insurance policyholders before the next brush with disaster." Clearly what he contemplated in S. 1710 is a system patterned after the FDIC. However, the type of powers granted to the FDIC although extensive, were established to regulate a specific and well defined problem, the financial condition and solvency of banks and the protection of depositors accounts from undue risk. "The regulatory objective" was to maintain bank solvency and protect the nations money supply.

It is essential to review the crisis condition that preceded the development of the FDIC in contrast to the financial environment today, to obtain a clearer picture of why federal regulation of bank solvency was a national requirement of the first order in 1933 while such federal regulatory presence is not needed today for the insurance industry and would be counter productive.

In 1933 banks were failing every day with over 1,000 banks closing their doors to depositors in that year and the trends were ominous. The money supply of our nation was in jeopardy, the confidence of our citizens in our nation's banks was at a low ebb, and the system by all accounts was fast eroding from within. There was not at this time an effective state regulatory function for the banking industry.

In contrast to those crisis conditions of the early 30's, the insurance industry has demonstrated important financial stability enabling it to pull through a period of successive and massive underwriting losses caused by surging claim costs and unforeseen inflationary conditions during the mid 1970's. Insurance carriers are now

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reporting positive operating results and financial conditions in the insurance industry are definitely improving, not deteriorating as was the condition with the banking system in the 1930's. Finally, insurance regulatory oversight has been active and increasing at the state level.

By all rights, those advocating federal regulation of insurance must be able to demonstrate that federal regulation or dual regulation would be an improvement on the current regulatory system. This case has not been made. As our statement points out dual regulation would lead to more regulation, litigation and uncertainty and to less competition and public protection.

The dual system for dealing with insurance company insolvencies contemplated under the bill will unfortunately, considerably lessen today's protection available to policyholders and third-party beneficiaries in the eventuality of insolvencies. Let me explain:

Since 1970, 48 states and the District of Columbia have enacted legislation to provide extensive protection to both policyholders and third-party beneficiaries victimized by property and casualty insurance company insolvencies. (Legislation is presently pending in Oklahoma, one of the two states without a property and casualty insurance company insolvency plan.) Most of the state plans are modeled after a bill drafted by the National Association of Insurance Commissioners (NAIC), the association of state insurance regulators. The NAIC model act calls for an assessment to be levied on all property and casualty insurers doing business in the states in which unpaid losses arise from a company's insolvency. This post

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assessment mechanism was selected for three reasons, 1) to prevent the accumulation of unnecessarily large surpluses such as the \$7.3 billion deposit insurance fund (1976) which has been amassed by the FDIC, 2) to keep to a minimum interference with insurance company operations, and 3) to keep insurance capital and surplus working actively to meet the increasing nationwide demands for insurance. Furthermore, a post assessment program can be implemented with no new administrative bureaucracy and at a minimum cost to both the industry and the public. It is important to emphasize that all licensed property and casualty insurance companies doing business in a state must participate in the insolvency mechanism in that state.

Title I of S. 1710 would establish a competing insolvency mechanism. However, S. 1710 makes no attempt to compete fairly with the state system. It allows participation in the federal program only for those companies which meet that degree of financial stability promulgated by regulation by the Federal Insurance Commission. One must assume that the degree of stability which will be required by those regulations will be substantial. Hence, only the stronger insurance institutions will be allowed to participate in the federal guarantee plan. If the state plans were to apply the same selectivity and be limited to companies with the highest financial integrity, the public would receive little or no protection against company insolvencies since those companies more likely to become insolvent would be excluded from both the federal and the state system. To the extent that the strongest financial companies elect to participate in the federal program it will then fall upon the weaker companies to

attempt to respond to the losses generated from insolvencies through state guarantee fund post assessments. It stands to reason that the state insolvency system would collapse in time.

An additional grossly unfair competitive advantage is provided the federal system because the legislation puts roadblocks in the way of companies desiring to leave the federal system but makes it very easy for a company to enter the federal system. Is it not reasonable to expect that once a company finds that a competitor may be in serious financial difficulty and that upon the insolvency of that competitor it would be called upon for a substantial assessment in case the insolvency materializes, that it would seek immediate participation in the federal guarantee program in order to escape the post assessment levy? Thus, companies are invited to avoid their obligations under state insolvency plans but are, in fact, effectively prevented from doing the same once they have been captured by the federal program.

A third grossly unfair and non-competitive advantage of the federal guarantee program is that once a company becomes part of the federal guarantee program it no longer has any obligation to the state insolvency mechanism. Yet, under a post-assessment system, assessments are made periodically to cover only the cost of claims settled and not all losses incurred. A company participating in a state insolvency mechanism would be in a position to avoid payment of future assessments simply by switching over to a federal guarantee program. If enough companies would take advantage of this escape mechanism, the ability of the state system to generate the

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the necessary funds to pay for insolvent companies would be substantially weakened.

Senator Brooke has pointed to the fact that "only eighteen states presently offer guarantee fund protection against a life insurance insolvency." We do not see how the establishment of a dual insolvency system would be of much assistance to those victimized by life insurance company insolvencies, since one would anticipate that the only companies allowed to participate in the federal program would be the least likely to become insolvent, no matter what their state of domicile. Let me emphasize that the federal guarantee insurance program will only protect the victims of insolvent companies participating in the federal program. Hence, those victimized by life insurance companies' insolvencies will have little or no better protection than they have at present.

A third point made by Senator Brooke is that where state guarantee funds have been operated on a preassessment basis, they have been "raided" by the state legislature and the funds amassed have not been available when needed. It is correct that more than \$200 million of those funds accumulated in the New York state insolvency fund were switched from bank certificates of deposit and federal government securities into New York City obligations. However, that doesn't mean that the insolvency fund in New York is unable to respond to either insolvency payments or special loans to assist in the rehabilitation of a company in financial distress. As a matter of fact, the New York state legislature has just authorized a substantial loan to be made to attempt to rehabilitate a relatively

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large New York insurer. Incidentally, it is not only state guarantee funds which are subject to the whims of legislatures. We have already seen that Federal guarantee funds are also subject to the whims of Congress. When the federal crime insurance program was enacted, Congress authorized payment of claims from the federal riot re-insurance pool accumulated by insurers for their protection in the eventuality of major riot losses. Thus, the ultimate use of any preassessment fund can always be subject to the whims of any legislative body -- state or federal.

The state insolvency fund system is still relatively new. Obviously it is in need of minor adjustments. State legislatures are responding to these needs. For instance, during the 1977 state legislative sessions, a number of state guarantee fund laws were amended to provide immediate access by the state insolvency mechanism to the assets of insolvent insurers. There are now eighteen states with laws allowing guarantee funds immediate access to such assets. Sixteen states have laws giving guarantee funds priority over general creditors for those assets and eleven states have provisions for premium tax offset for assessments paid by member insurers to guarantee funds.

Ultimately, it is the insurance buying public which pays for the assessments related to insolvency, whether these assessments are on a preassessment base or post-assessment. Since 1969 property and casualty insurers have been assessed approximately \$161 million. Had these same companies been subject to the one-quarter of one percent premium tax "pre" assessment suggested in S. 1710 they would

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have paid upwards of \$1 - billion into the federal insurance guarantee program. The fees of the alternative federal insolvency program obviously would have been much higher than the actual state fund operating costs. The savings to the public are evident in the state fund approach and need no further elaboration. (A Fund assessment table is attached as an appendix to this statement).

In conclusion, the federal guarantee insurance program proposed by S. 1710 will not enhance public protection against insurance company insolvencies. In fact, it will substantially detract from the existing protection enjoyed by the public. It will establish a mechanism whereby the larger and the stronger insurers will be able to avoid their fair assessments to insure the protection of victims of company insolvencies.

B. Creation of a New Bureaucracy

S. 1710 will require establishment of a vast new federal bureaucracy. To fully appreciate the implication of dual regulation we have examined the proposed Federal Insurance Commission in order to answer the following questions:

1. How broad are the powers and responsibilities of the proposed Federal Insurance Commission, both specified and implied?
2. Isn't it reasonable to assume that a Federal Insurance Commission once established would extend its regulatory authority beyond solvency and chartering to include insurance marketing, rating and operation?

In answering this question one must consider the wide-

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spread political interest in insurance in Congress and the advocacy of federal solutions that are increasingly being presented to ameliorate nationwide social and economic problems.

3. How massive might the proposed Federal regulatory authority become in order to carry out the responsibilities set forth in its charter?
4. To what extent would federal insurance regulatory program/operation overlap, duplicate and/or conflict with state insurance regulation?
5. Should one expect that insurance company regulatory reporting requirements and paperwork, already an enormous burden and expense, would proliferate even further as the federal and state regulatory systems compete for influence and power?
6. To what extent will competing regulatory systems at both the state and federal level inevitably lead to the development of untoward additions, rules, and regulation of an industry which by all accounts is already subject to extensive regulation in all 50 states?
7. How can an ever increasing level of regulation spurred by a vast federal insurance regulatory system be reconciled with the commitment of the Carter Administration to reduce the scope and impact of regulation in general and to shrink the federal regulatory bureaucracy in particular?
8. The proponents of federal regulation believe it would pro-

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vide additional financial stability to the insurance industry. Wouldn't the existence of two vast competing regulatory systems lead to just the opposite -- a prolonged period of uncertainty, litigation and instability as new regulatory relationships and responsibilities must be established and restructured?

These major questions deserve further discussion.

The proposed responsibilities and powers of the Federal Insurance Commission specified in S. 1710 are both extensive and concentrated. They parallel in part the oversight responsibilities of both the Federal Deposit Insurance Corporation (FDIC) which insures demand deposits in national and state banks and the Comptroller of the Currency Division of the Treasury Department which regulates banking operations and charters national banks. The Federal Insurance Commission would also include, of course, all the programs and responsibilities of the Federal Insurance Administration now in the Department of Housing and Urban Development.

Given the extent of its power and the political pressures which would undoubtedly affect the Commission, it is quite probable that the Commission would be prodded to expand its regulatory role well beyond solvency issues to involve most if not all aspects of insurance company management. To demonstrate this point, just consider the nature of the actual powers proposed for the Commission. These powers must be viewed in the context and the environment in which they would be employed. Policyholders, consumer groups and others have increasingly been seeking political solutions to insurance problems

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not only at the state level but in Washington, as well. And it is under this environment of complex and increasing political pressures that the Commission would exercise its powers.

A brief review of the extensive regulatory powers available to the Federal Insurance Commission and the current regulatory and political environment in which it would operate is illuminating. One must first recognize that the Commission would not only have broader powers than the original Federal Deposit Insurance Corporation, it would quickly become active in regulatory areas that are ostensibly left to the states, i.e. insurance marketing and rating. One would expect economic regulation to increase significantly rather than to diminish under a dual federal state regulatory system. Consider:

- .. The Commission's power to deal with potential discrimination would enable it to gather extensive data on marketing practices and operations. It could do this by holding hearings, issuing subpoenas to witnesses and, if necessary, penalizing insurers that are federally chartered. The Commission could initiate such investigations if it believed that discrimination was related to market classification, underwriting and rating practices. The question, therefore, arises whether the responsibility for markets and rating would be left entirely to state regulators.
- .. The powers that the Commission would assume en masse from the Federal Insurance Administration would enable it to become directly involved in insurance availability issues (the U.S. Government Organization Manual states that FIA is now directly involved with insurance availability problems). Since insurance

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availability and affordability are increasingly mentioned in the same breath, this oversight power provided to the Commission would provide it with a blank check to analyze rates, rating practices and residual market plans in direct competition with state insurance regulators. This would be a situation certainly not intended by the authors of S. 1710.

.. Developing and monitoring criteria for loss reserve adequacy would also provide much room for the Commission to maneuver, thus enabling it to monitor, if not regulate insurance rates for adequacy.

.. Finally, the regulatory power of the Commission to determine underwriting capacity of federally chartered insurers directly impacts insurance markets, insurance availability and could enable it to dictate what lines of insurance could be written and how large the premium writings could become in each line for certain insurers.

Beyond these very extensive powers, the proposed Federal Insurance Commission can issue additional rules and regulations and may have additional powers not specifically enumerated that would assist it in carrying out the provisions of the Act. In fact, the Commission would be empowered to determine what other lines of business incidental to their insurance operations insurers could engage in (Section 202(e)(8)). In short, almost every aspect of managing a federally chartered insurance company would be subject to in-depth regulatory oversight.

Consider also the provision in the proposed legislation that all three commissioners cannot be affiliated with the same political party. This provision clearly acknowledges that political pressures and considerations are expected to impact the operations of the proposed Federal Insurance Commission. In addition, there is a six-year term of office for each of the three commissioners, but no mention is made in the bill of how a commissioner could be removed from office for poor management or bad judgement.

In summary, can anyone seriously doubt that economic regulation would not increase given the extent of the powers granted to the Federal Insurance Commission and the political environment in which they would be employed?

Sec. 202(c)(4) of the bill contains another open ended power. This provision would directly unsettle if not severely curtail the securities markets for publicly held insurers. It would additionally, pit the proposed Federal Insurance Commission directly against the Securities and Exchange Commission. Under Section 202(c)(4) The Federal Insurance Commission has the power to examine, audit and use its other extensive regulatory authorities at its discretion with respect to any "person" exercising or possessing effective control of a federally chartered insurer. Under Section 202(f) the Commission would require that all those who have such effective control must report periodically "in such form and in such detail as the Commission may prescribe."

Consider the implications of these provisions. A major corporation who owns an insurer that is federally chartered would

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have to open itself up to examination by yet another federal regulatory body and to issue periodic reports on their ownership. But this would not be limited to corporations; it would ostensibly apply to individual investors, trusts, pension funds and other investors who may have effective control of a federally chartered insurer. The term "effective control" incidentally is not defined in this legislation. It could be interpreted to include situations where 10% or more of an insurers stock was held by one person or organization (The SEC standard for disclosure) or even less than 10% if such stock had very wide distribution.

The likelihood of double regulation of controlling interests and securities by the SEC and the Federal Insurance Commission would undoubtedly unsettle the market for insurance equities and make them less attractive to investors. It could in fact lead to a reduction in security prices and to risk capital available to insurers, as well as increased regulation.

The effects would be the direct antithesis of the very objectives sought by this legislation.

The legislation could have serious implications as regards insurance availability. The Commission is provided authority to prevent certain alien insurers from transacting business anywhere in the U.S., unless such insurers have previously sought a federal charter. It is odd that legislation be contemplated to curtail the insurance market when all indications are that the insurance public requires broader markets than have ever existed.

In order to estimate how massive and complex a federal

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Insurance bureaucracy would become we have tentatively identified the major organizational components which would be required at a minimum to manage its responsibilities. This listing of organizational and functional components was established with the understanding that the Federal Insurance Commission would:

1. Have responsibilities in part equal to the FDIC (bank insolvency) and the Comptroller of the Currency (bank chartering operating regulations)
2. Include all programs and responsibilities of the present Federal Insurance Administration in HUD
3. Operate as an independent and self sufficient Federal Agency as outlined in Title I, Section 101(c).
4. Substantially decentralize its line operating personnel into the field to cover the ten federal regions.

The following are possible organizational components which would likely be necessary in the proposed Federal Insurance Commission under S. 1710 (*Denotes possible field decentralization).

1. Office of the Commissioner (Immediate staff/Executive Secretariate)
2. Advisory Committee/oversight committees
3. General Counsel
(chartering, rule making/legislation, liquidation, federal state regulation, appeals)
4. Budget and Finance (asset management)
5. Controller/Treasurer (accounting, control)
6. Management and Data systems (performance monitoring, early

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warning system, management information, programming,
data storage)

7. Personnel (employment, training, career development,
employee safety, upward mobility)
8. Administrative support (procurement, space, contracting,
travel, security library, administrative law judges, hearing
examiners)
9. Research division: chief economist, standards development,
regulatory and policy analysis, program development and
evaluation, corporate planning
- * 10. Division of Corporate Audits and Examinations
- * 11. Office of Policyholder and Consumer Affairs
- * 12. Inspector General's Office (investigations)
- * 13. Intergovernmental Operations (state liaison, international)
- * 14. Division of insurance regulation and supervisions
 - corporate regulation - investment and reserve management
 - merger acquisition - compliance certification
 - enforcement - non-insurance functions - chartering
 (solvency
 (discrimination
 (consumer laws
15. Bureau of Competition
16. Plus

All organizational components and personnel of the Federal
Insurance Administration

 - Flood insurance
 - riot reinsurance/FAIR
 - federal crime insurance
 - analytical, management and support functions

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From another perspective one can estimate the potential size of the Federal Insurance Commission by comparing it to the FDIC, after which it was patterned in part, the Federal Insurance Administration which it would absorb and the Comptroller of the Currency function which conducts parallel and extensive examinations of federally chartered banks. It is not improbable that a Federal Insurance Commission once fully operational would employ several thousand employees both in Washington and the field with an operating budget that could easily exceed 100 million dollars. One need only observe that:

...state Insurance Departments currently employ an estimated 54,000 personnel with an operating budget estimated to exceed \$136.5 million.

...The operating budget of the Federal Deposit Insurance Corporation alone for 1976 was 107 million dollars with 3535 total employees, of which 70 percent were located in the field. The FDIC was responsible for supervising 8979 commercial and mutual savings banks, with assets of \$335.3 billion, according to their 1976 Annual Report.

...The Comptroller of the Currency has upwards of 3000 employees with an operating budget in excess of \$68 million and is responsible for examining 4600 national and District of Columbia banks.

...The Federal Insurance Administration has 298 employees and an annual operating budget of more than \$76 million.

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To what extent would duplicate and/or parallel state and federal regulatory systems require an increase in paper work? Let's consider for a moment those areas where separate and different reports would ostensibly be required by both state and federal regulators. The overlap would be extensive for those companies with state charters who join the federal guarantee program.

1. Overall reports on financial condition, investments, claim reserves, operations.
2. Early warning systems in operation at both the state and federal level.
3. Probable special reports on insurance availability and affordability that could include closed claims studies.
4. Reports on rate adequacy to meet minimum reserve requirements.
5. Reports on rating and classification practices to monitor potential discrimination.

It is instructive to analyze the implications of this concern for duplicate and parallel reporting. Section 107(b) of the bill authorizes the Federal Insurance Commission to establish "an early warning system." Further, it states that "In order to render possible comparison and thus make available broad financial and statistical data, any such 'early warning system' may include both federally guaranteed insurers and other insurers." (Emphasis added) The phrase "and other insurers" clearly gives the Federal Insurance Commission the authority to require reports, data, etc. from all insurers even though they may be state chartered and do not participate in the federal guarantee fund.

IV. CONCLUSION

The goals of insurance regulation were stated in 1960 by the NAIC to be:

1. "That insurance coverages desired by the public should be generally available to the public from licensed insurers;
2. The cost of such insurance coverages to the public should be reasonable and not extensive;
3. That the solvency of insurers should be maintained in the interest and for the continued protection of their policyholders;
4. That each insured should bear his fair share of insurance cost."

As evidence of their durability, these principles are just as valid today as they were in 1960. Simply stated, these goals seek to maintain a viable insurance market in which consumers may secure their insurance needs at reasonable costs, in a competitive environment.

The means of achieving these goals, however, are necessarily complex. While each of these objectives are not necessarily mutually exclusive, they do conflict, to some degree. For instance, it would be simple to insure that "solvency of insurers should be maintained" by requiring that minimum insurance rates be pegged to meet the needs of the least efficient insurers. But, this would unquestionably lead to excessive insurance prices.

The true measure of the efficiency of insurance regulation is not how well each of the above mentioned objectives is reached by and of itself, but how well they are balanced in the actual

world. In the recent past, in a few states, the regulation of insurance has been politicized through the simple mechanism of preventing adequate rate levels. While this may have temporarily provided consumers with "bargain price" insurance, in those states where this has occurred the market has become unstable, resulting in a serious availability crisis. Thus, these short-run, temporary consumer advantages are quickly lost and, in the long run the insurance public is ill-served by such short-sighted policies.

It is obvious that to achieve good, balanced insurance regulation, the responsibility for achieving the regulatory ends cannot be "split between competing sovereigns."

Yet, this is exactly what S. 1710 would do. It would create, within the federal establishment, a federal government authority which will compete and share with state government the responsibility to regulate the insurance business.

S. 1710 goes considerably beyond its stated objectives - to authorize the issuance of federal charters to insurance companies and to establish "alternate federal insurance guarantee mechanisms." It will ultimately totally realign and unsettle the competitive structure of the insurance business, leading to considerably greater territorial market concentration in existence today. The effect will be less competition, less service and less public protection. It will also lead to more regulation, more litigation, greater uncertainty and certainly more paper work.

S. 1710 would bring into being, extensive regulatory changes...

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seriously disrupting the operation of the existing state insolvency protection mechanism. Again, the public will have less protection than it has today but will pay a greater cost for the reduced protection.

Additionally, the legislation will undermine the security's market for publicly held companies, while insurance investments may well become highly concentrated in only the highest quality blue chip investments.

Finally, S. 1710 will require the establishment of a vast new federal bureaucracy at a time when the President, Congress, businessmen and the electorate have made it clear again and again that what this country requires is less regulation and a contraction of existing federal regulatory agencies. This is particularly valid with respect to the concern for the prospect of concentrated regulatory power in a few hands in Washington.

Comparison of Estimated Federal Guarantee Fund
Accumulation versus Actual State Guarantee Fund Experience
1969-1976
 (in millions)

Year	Net Premiums Written/ All Prop. Liab. Cos. ^{1/}	Estimated Federal ^{2/} G'tee Fund Accum. Assuming .25% Fee	Actual State ^{3/} Guarantee Fee Experience	Estimated Excess Federal Guarantee Accumulations
1969	\$ 29,224.9	\$ 73.1 ?	\$ 9.4	\$ 63.7
1970	32,867.0	82.2	13.5	68.7
1971	35,714.9	89.3	18.5 ?	70.8
1972	39,317.5	98.3	13.5	84.8
1973	42,479.8	106.2	14.6	91.6
1974	45,152.4	112.9	20.0	92.9
1975	50,000.0	125.0	56.8	68.2
1976	59,500.0	148.8 ^{4/}	15.0	133.8
	\$334,256.5	\$835.8 ^{4/}	\$161.3	\$674.5 ^{5/}

- 1/ Includes accident and health written by property liability companies.
 2/ Assumes that all companies opted for federal guarantee at .25%
 3/ As reported in the AAJ study of residual markets, AAJ Bulletin No. 77-6 (2/3/77).
 4/ Does not reflect impact of compound interest on fund accumulation.
 5/ Source: Best's Aggregates and Averages 1975 and 1976 figures are preliminary.

The CHAIRMAN. Thank you very much, Mr. Maisonnier.

Our final witness is Mr. Arthur C. Mertz. You have a 35-page statement, and if you could abbreviate it, we would appreciate it.

Mr. MERTZ. I would be very happy to abbreviate my remarks, Mr. Chairman.

STATEMENT OF ARTHUR C. MERTZ, PRESIDENT, NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

Mr. MERTZ. My name is Arthur C. Mertz, and I am president of the National Association of Independent Insurers, NAII for short.

We are a voluntary national trade association of more than 600 property and casualty insurers of all sizes. Most of our companies are small and medium sized.

I want to emphasize both our filed statement and my testimony today are addressed solely to the casualty property lines of business.

Since our association was founded in 1945, the year the McCarran Act was adopted, NAII members have played a leading role in opening and preserving the channels of competition under the State regulatory system created in response to that act.

We were the first, incidentally, to support competitive rating laws and today we, like other segments of the business, are seeking the adoption of more such laws.

We believe the actual effect of S. 1710 would be to substantially repeal the McCarran-Ferguson Act, under which the Congress in 1945, after much study and debate, reaffirmed that "the continued regulation and taxation by the several States of the business of insurance is in the public interest."

It may be argued that S. 1710 does not really impact McCarran, because the decision to seek Federal charting or guaranty status is optional. We disagree. A system which empowers members of our industry to choose who shall or who shall not regulate them, in such vital areas as rates, reserves, investments, and so on, is certainly drastically different than is embodied in the McCarran Act, which reserves to Government the power to make that choice of who regulates whom, the State government in the first instance, and Congress in the last.

In adopting S. 1710, Congress would be abdicating the ultimate legislative responsibility for determining who shall regulate insurance and would vest that responsibility in the hands of the regulated. In actual effect this power would gravitate to a handful of the very large insurance companies.

I have nothing against large insurance companies. We have some large members ourselves. Not only would those larger companies be able to choose which regulator they consider advantageous for themselves, but they could largely chart the destinies of their smaller competitors.

This leads to our second major reason for opposition; namely, that S. 1710 could invite the destruction of competition by the elimination of many small insurers from the market, a result I am sure the sponsors of this bill never intended or contemplated.

For one thing, a move from State insolvency funds to Federal guaranty status by any significant number of large insurers would thrust

intense cost burdens and competitive pressures on the insurers remaining under the State funds and exclusive State supervision.

Second, S. 1710, as written, would give federally chartered insurers substantial competitive advantages over their State-chartered competitors in the pricing of insurance. Those who opt to be completely exempted from every State regulatory control over rates, could raise or lower or manipulate their prices virtually at will, and they could thereby outmaneuver their State-chartered competitors at every turn.

Today the multistate large companies already enjoy many natural advantages over their smaller more localized competitors. But at least all companies have to play under the same set of rules, standards, procedures, and codes.

Equally important is the fact that small companies today are assured of continued availability of the composite statistical data and the filed rates and supporting data of all companies, including the very large companies, whose experience is needed to provide a proper basis for meaningful trend indicators for the future.

This bill would permit the larger insurers to escape all of those requirements, including the filing and review of rates and the furnishing of data. This would make the present competitive struggle far more difficult, perhaps impossible for scores of smaller companies. They would be unable to price their insurance competitively and profitably and this would be true whether or not they themselves opted for Federal chartering.

If they did opt for Federal chartering, not because they wanted to, but because they were pressured into doing it, they would thereby subject themselves fully to the Federal antitrust laws, and would have added to the already severe problems I have just indicated, where they would lack credible data, they would have added to those problems the constant fear that any parallelism or tracking of the rates and rate changes of their competitors and any cooperative action in the use of advisory services for trending rates to the future, however necessary they were to them, could invite Justice Department action or private treble damage suits, or both.

I must say we are not reassured by what the Department of Justice has had to say on this point. They indicated they have not studied in depth the impact of this bill on small insurers.

I want to assure you we have, and we are gravely concerned about that impact.

In sum, in our view this bill would operate as an anti-small-business, pro-big-business measure, even though again I am sure it was not so intended.

Our next objection is that S. 1710 would deprive consumers of many vital regulatory safeguards and rights and remedies which they now enjoy under State law. It would give the federally chartered insurers complete freedom to raise or lower rates at will.

Now the prospect of totally unregulated pricing freedom—I am not talking about “open competition” rating as in California, because there are standards there, and there are procedures there—the prospect of totally unregulated pricing freedom, subject only to the broad constraints of antitrust, is obviously an attractive one to any business entrepreneur. But sound judgment tells us that this theoretical utopia

is simply not realistically attainable in our business. It does not fit our business. And it never fit our business.

Congress, in 1945, concluded it did not fit our business. The most we believe we can reasonably ask for in the way of regulatory systems are those which eliminate burdensome prior approval procedures, but still require all rates and rate changes to satisfy rating standards of adequacy, nonexcessiveness and nondiscrimination. That is in a nutshell what the "open competition" rating law does. It is not unrestricted competition, it is competition subject to the regulatory standards.

At the present time technically trained officials in every State are monitoring the entire property casualty pricing picture on the consumers behalf, under specific standards. We seriously question whether consumers, or legislators in their behalf, would be satisfied for very long to lose those safeguards and that monitoring.

We believe the advent of sizable rate increases by any large insurers choosing the Federal chartering route under S. 1710 would soon give rise to heated demands for imposition of stringent rate control by the Federal Government.

This is one of the forms of bureaucracy we and I think others have indicated we are concerned about.

The States also now are monitoring many many other areas besides rates. Commissioner Stone just indicated that in his department they process 10,000 consumer complaints, presumably in all lines of insurance, annually. Who, we might ask, under S. 1710, is going to monitor the consumer complaints for federally chartered insurers, unless you set up one heck of a big staff and bureaucracy to do it. And Commissioner Stone's figures are just for Massachusetts.

There are many other ways in which this bill will in our opinion lessen overall regulatory effectiveness and operate to the disadvantage rather than the benefit of the consumer.

We enumerate them on pages 13 to 22 of our statement. That is, the regulatory responsibility would be divided and diffused, there would be duplication, overlapping, there are many areas where there are uncertainties, and certainly the grant of power to the Federal Insurance Commission is in many instances so broad as to permit regulation by fiat.

The remainder of our statement is devoted to the reasons why we do not believe a case has been made for Federal involvement by S. 1710, and why we believe the case for continued State supervision of our business is stronger than it ever was.

We also point out that we believe that the banking regulatory system which has been cited as a precedent for S. 1710 is neither an appropriate example for comparative purposes by the nature and makeup and function of the business, nor is it a convincing example, because there are apparently problems in that field which indicate the solutions have not all been worked out.

Second, we do not believe that the insolvency problem for property and casualty insurance currently or over the last several years is of sufficient proportions to warrant the imposition of a huge Federal guarantee fund and the accompanying regulatory system that must go with it on top of the State system.

I believe this point has been pretty well discussed by the distinguished Commissioners who were here. I would just add one footnote. That is, since the GEICO saga has been mentioned several times, we certainly don't see how it can be used, properly used, as any evidence for support of the bill. We think it is a rather overwhelming success story as to how well the present State system does work and can work.

We finally show in our statement how over the past three decades the States have overwhelmingly responded to the congressional intent of the McCarran Act, and have developed a regulatory system which promotes competition and solvency, fosters innovation, and assures an constantly expanding market capacity, all in the public interest.

While that system is not perfect, it is constantly being improved, and the improvements in recent years have been dramatic, especially in areas of examinations and solvency surveillance.

Certainly our business, like others, faces a lot of problems. Most of them stem from spiraling inflation and the cost of the ingredients which go into liability and property insurance losses.

We appreciate the concern expressed by the sponsors of S. 1710 and by various members of this committee over those problems. But we submit that S. 1710 will do nothing toward solving those problems. Conversely, in the ways we have indicated in our statement, it will substantially add to the operational costs of the insurance system, and the regulatory process, and would, by creating confusion over lines of responsibility, undermine the effectiveness of that process.

We therefore respectfully urge this distinguished committee not to act favorably upon this measure.

Thank you.

[The complete statement of Mr. Mertz follows:]

**.. STATEMENT
OF
THE NATIONAL ASSOCIATION OF INDEPENDENT INSURERS
BEFORE THE SENATE BANKING,
HOUSING AND URBAN AFFAIRS COMMITTEE
IN RE: S-1710**

September 13, 1977

The National Association of Independent Insurers is appreciative of this opportunity to present its views on the subject of federal chartering and regulation of insurance companies as embodied in S-1710.

NAII is a voluntary national trade association of more than 600 insurers. * Our organization provides a representative cross-section of the casualty and fire insurance business in America. Our members range in size from the smallest one-state companies to the very largest national writers: they comprise both stock and non-stock corporations and reflect all forms of merchandising -- independent agency, exclusive agency, and direct writers. They include insurers serving a general market and those that specialize in serving particular consumer groups such as farmers, teachers, government employees, military personnel, and truckers

Since its founding in 1945, NAII has been dedicated to fostering healthy competition in rates, coverages and services under sound state regulation. The Association has played a leading role in broadening the channels of competition under the state casualty/property regulatory laws in the post-McCarran Act period,

*405 members and 204 statistical subscribers.

and its member companies have provided a major share of the rate competition and product and marketing innovations under those laws.

The record of more than 30 years of healthy competition and continued growth by our industry under state regulation dictates that we must oppose any unwarranted federal intervention in the regulation of insurance, such as that proposed by S-1710.

Our principal reasons for that position are:

- (1) S-1710 in actual effect will substantially repeal the McCarran-Ferguson Act and establish a dual system of regulation in which vital legislative responsibilities are abdicated into private hands.
- (2) S-1710 will not promote competition but will invite the destruction of competition in the insurance business through elimination of many small business enterprises.
- (3) S-1710 will deprive consumers of many vital regulatory safeguards, rights and remedies they now enjoy under state law, and will weaken overall regulatory effectiveness.
- (4) The system created by S-1710 will be unduly costly, wasteful ~~and inefficient.~~
- (5) The banking regulatory system which has been cited as a precedent for S-1710 provides an inappropriate and unconvincing example.

(6) Enactment of S-1710 is unneeded and unwarranted because the state insurance regulatory systems have proven fully responsive to the public needs by promoting competition and solvency, fostering product development and innovation, and assuring a constantly expanding market capacity in the insurance business, while the state insolvency guaranty funds obviate any need for a federal fund.

(1) S-1710 in actual effect will substantially repeal the McCarran-Ferguson Act and establish a dual system of regulation in which vital legislative responsibilities are abdicated into private hands.

The actual effect of S-1710 will be to rewrite and substantially repeal the McCarran-Ferguson Act (P.L. 15, 79th Cong.) under which the Congress in 1945 after much study and debate reaffirmed that "the continued regulation and taxation by the several states of the business of insurance is in the public interest". Amazingly, S-1710 contains absolutely no reference to that monumental statute under which "Congress has posited a regime of state¹ regulation..." in the words of the U. S. Supreme Court.

Both the text and the history of the McCarran Act denote a strongly-manifested Congressional intent that no future federal inroads were to be made upon state regulatory jurisdiction by implication or by inadvertence. Any move by Congress to take back any of the regulatory prerogatives it reaffirmed to the states under the McCarran Act must therefore be both studied and explicit,

1. State Board of Insurance v. Todd Shipyards Co. (1962) 370 U. S. 451.

and, we believe, founded only upon a clearcut finding that in some way the states by failing to "regulate" our business have violated the trust reposed in them under the Act.

As will be pointed out later in this statement, no such finding would be possible. Indeed, the case for continuation of state regulatory jurisdiction over our business is immeasurably stronger today than it was 33 years ago.

It may be argued that S-1710 does not really impact the McCarran Act because the decision to go the federal route is "optional" with the insurance companies themselves. We disagree. A system which empowers members of our industry to choose who shall and shall not regulate them in such vital areas as rates, reserves and investments is certainly a drastically different one than is embodied in the McCarran Act, which clearly reserved to government the power to make that choice -- state government in the first analysis and Congress in the last. In adopting S-1710 Congress would abdicate the ultimate legislative responsibility and authority for determining who shall regulate insurance, and would vest it in the hands of the regulated.

In actual effect, as will be more fully demonstrated, this pivotal decision-making power would gravitate to a handful of the very largest insurance companies. Not only would they be able to choose which regulatory arena they consider advantageous for themselves, but by their decisions they could very largely chart the courses and dictate the destinies of their smaller competitors.

It seems clear that S-1710 would substantially repeal the McCarran-Ferguson Act and substitute a radically different system of regulation than that Act contemplated. It seems equally clear that the dual system sought to be substituted is so fraught with defects, deficiencies and dangers that it should not be given serious consideration by the Congress.

(2) S-1710 will not promote competition but will invite the destruction of competition in the insurance business through elimination of many small business enterprises.

In our considered judgment, the ultimate effect of S-1710 would not be to increase competition (as is perhaps intended), but to invite the destruction of competition by the elimination of many small insurance companies from the market.

As written, S-1710 may be well suited to the operations, needs and wishes of certain very large insurers with countrywide operations. What it ignores is the total structure of the property/casualty insurance industry and the vital role that small and medium-sized companies play in it. These many hundreds of companies provide much of the basic competition that generates reasonable and stable prices and new products. They are a key part of the insurance economy.

Under S-1710 the only real "freedom of choice" would repose with the large insurers. Their decisions -- both as to the regulatory arena they consider advantageous and as to their future rating and market practices -- would largely determine the ultimate destinies of their smaller competitors. Some ways in which this could come about include the following:

First, a move from state insolvency funds to federal guaranty status by any significant number of large insurers would thrust intense cost burdens and competitive pressures on the insurers remaining under the state funds and exclusive state supervision.

If, for example, just the top twenty companies in the property/casualty insurance business should choose federal chartering or federal guaranty protection, it would cause the state guaranty funds to lose over 50 percent of their premium base for assessments for losses and expenses. This and other factors would greatly increase the burdens and pressures on the insurers remaining under the state funds.

Additional strong pressures would be created if federally guaranteed insurers began to advertise that fact much the same way banks presently advertise they are insured by FDIC. Members of state guaranty funds are not allowed a similar privilege. This would give federally guaranteed companies a significant competitive advantage.

That advantage would be further enhanced if lending institutions required insurers of property under mortgage to be federally insured, or if any form of preferred treatment were given to federally guaranteed insurers by such lending institutions or by anyone involved in the insurance marketing system.

Secondly, S-1710 as written would give federally chartered insurers substantial competitive advantages over their state chartered competitors in the pricing of insurance. With narrow exceptions,² federally chartered insurers would be exempted from every state rate regulatory control. They could raise or lower or manipulate their prices at will, so long as they observed the very general boundary lines set by the federal antitrust laws (essentially, avoidance of action in concert) and by the anti-discrimination provisions contained in S-1710 itself.

A host of opportunities would exist for federally chartered insurers to exploit market and pricing opportunities and outmaneuver their state chartered competitors at every turn. Today, large multi-state companies already enjoy many natural advantages over their smaller, more localized competitors -- such as sheer size, spread of risk, technical and research resources, etc. But they are at least all subject to the same explicit rating standards, procedures and supervisory controls. Equally important, under the prevailing state laws and regulations, small companies are assured of continued availability of and access to the composite statistical data, (as well as the filed rates, manuals and supporting data) of all companies, including the very large companies whose experience is needed to provide a credible basis for meaningful trend indicators.

2. The two exceptions of Subsections 204(a)(4)(A) and (B) of the Act, dealing with residual market plans and with lines of insurance where competition is for the producer's business rather than the ultimate customer's.

S-1710 would permit the large insurers to escape all these requirements of the state rating laws³, including the filing and review of rates and the furnishing of data. This would render the present competitive struggle far more difficult -- perhaps hopeless -- for scores or hundreds of small companies.

It might be asked: Why couldn't the smaller companies solve this problem by simply opting for federal chartering themselves? If they did so opt, it would of course confirm the predictions of many observers that adoption of S-1710 will ultimately visit full-blown federal regulation upon our entire industry.

There are a number of reasons, though, why the farsighted small insurer views the federal chartering "option" under S-1710 as a snare and delusion rather than a meaningful and practical option.

For one thing, once the vital informational spigot of large company experience data and rate filing information has been shut off by the departure of a significant number of those companies from state rate regulatory jurisdiction, the ability of many small companies to navigate ratewise will be irreparably damaged. This will be true whether or not a small company itself opts for federal chartering.

3. Other than the two narrow exceptions noted under footnote 2.

Actually, the federal chartering route will in our Association's view seriously compound the problems and perils of most small companies (and even some large companies) that choose it. Certain large company managements may feel that the prospect of unfettered pricing freedom which S-1710 seems to offer at the go-in is attractive enough to outweigh the cost burdens and uncertainties federal chartering will entail and the broad grants of vaguely-defined powers it gives to federal regulators. (As we will point out later, we believe any freedoms the Act affords any federal charterees to raise prices may turn out to be short-lived.)

But for many small and medium-sized companies federal chartering would be no bargain at all, even at the go-in. Deprived of a broad base of experience and rating information including the larger companies' input, and lacking a credible volume of their own individual experience, they will be unable to price their insurance competitively and profitably -- whether or not they opt for federal chartering.

But if they do choose that route and thereby subject themselves fully to the federal antitrust laws, they will have added to their already severe problems the constant fear that any "parallelism" or "tracking" of the rates, rate changes and classifications of their competitors, and any cooperative action in the use of advisory rating services, however necessary and well-motivated, may invite Justice Department action or private treble damage suits or both. Nor can they afford the luxury of high-priced antitrust counsel to guide their every step, as their large competitors can. Indeed, the large insurer will have proportionately less need for such costly counseling, because it can manage pretty well in making pricing decisions on the basis of its own individual experience base and research and actuarial resources.

In sum, S-1710 is an anti-small business, pro-big business measure pure and simple. It would enable a handful of very large insurers to increase drastically their present natural advantages over smaller competitors, and ultimately to squeeze them out of the market. The smaller companies could not survive price manipulation by large competitors. They could not support two regulatory systems and the costs of duplicative examinations. They could not afford the additional staff and expert counseling needed to assure that they are in constant compliance with myriads of state and federal laws and regulations. They could not afford the increased costs of the federal guaranty fund and its concomitant impairment of their capacity. They could not stand restrictive standards which will inhibit their investment flexibility. And they could not price their product soundly without benefit of jointly produced industry data including large company data, and without the historic right given them under the McCarran Act to use that data in their pricing so long as that use is regulated by the state insurance departments. Thus, many small insurers would be forced out of the property/casualty insurance scene and a major source of competition, innovation and public service would be destroyed.

(3) S-1710 will deprive consumers of many vital regulatory safeguards, rights and remedies they now enjoy under state law, and will weaken overall regulatory effectiveness.

As noted, the Brooke bill gives federally chartered insurers virtually complete freedom to raise or lower rates at will, as long as the broad boundary lines of the federal antitrust laws (essentially, avoidance of concerted action) and the general anti-discrimination provisions of S-1710 are not overstepped.

While the prospect of totally unregulated pricing freedom is obviously an attractive one to any business entrepreneur, sound judgment tells us that this theoretical "utopia" is neither realistically attainable or sustainable in the property/casualty insurance business. The most we believe can be justified, achieved and retained for our business are regulatory systems which eliminate burdensome prior approval procedures but do require all rates and rate changes to satisfy rating standards of adequacy, non-excessiveness and non-discrimination, and which require the regulator to continuously monitor the rating and competitive picture to assure that those standards are observed.

At present, consumers in every state can take comfort in the fact that technically-trained public officials are monitoring the entire property/casualty pricing picture on their behalf, under statutory standards explicitly prohibiting excessive as well as inadequate or unfairly discriminatory rates. They also have geographically close at hand, through those same officials, a simple, inexpensive administrative avenue to seek redress of any alleged grievance concerning overcharging or other improper treatment.

Would consumers, and legislators on their behalf, be satisfied to lose these specific safeguards and remedies? We do not think so. The advent of a succession of widespread, sizeable rate increases by large insurers choosing the federal chartering route under S-1710 would soon give rise to heated demands for inauguration of stringent rate controls by the federal government.

Both functionally and structurally, the antitrust laws simply are not an appropriate mechanism for dealing with property/casualty insurance ratemaking. They are completely lacking in any standards or supportive provisions dealing with the subject of rate reasonableness as such. As long as there is no evidence of action in concert or restraint of trade companies will be able to charge anything the traffic will bear. The Justice Department itself has no technical or enforcement apparatus for inquiring into or dealing with the vast, highly complex rating systems of hundreds of insurers. And how could that Department possibly process and act on the thousands of consumer inquiries regularly handled by insurance departments all over the country, asking whether their premiums are "reasonable" and "lawful".

Thus, S-1710 would soon give rise to consumer demands for federal rate legislation and the creation of a vast additional federal bureaucracy on top of the huge bureaucracy S-1710 already will require.

The prevailing forms of state regulatory systems are basically well-suited mechanisms for promoting competition, protecting all the interests of the consumer, and providing the type of orderly regulatory framework for a highly risky business like ours. Those systems permit regulated, voluntary joint action, and vigorous competition to operate side by side. The combination of the two forces promotes basic continuity, efficiency, innovation and progress. It provides a framework for companies

of all sizes and merchandising systems of all types to vie for a place in the market. While room exists for improvement of the rating laws of some states, this provides no grounds for emasculation of state regulation and ultimate superimposition of a huge federal rate regulatory bureaucracy.

There are many other ways in which S-1710, by diffusing and obscuring the present clearly-defined lines of insurance regulatory responsibility and authority, will deprive the consumer of vital safeguards and will weaken overall regulatory effectiveness.

To regulate effectively, a regulatory agency needs clear-cut jurisdictional authority over not just a part but all of each company's operations and practices which bear on vital questions of soundness and solvency, and fairness, honesty and reasonableness in dealing with the public.

As will be more fully demonstrated later in this statement, the state commissioners now do possess the power and responsibility to regulate, and are most comprehensively regulating, every aspect of casualty/property insurance company operations and practices.

For federally chartered insurers, S-1710 would (as already noted) abolish certain regulatory safeguards vital to the consumer. The remaining bundle of supervisory responsibilities would in some cases be divided up, and in other cases be reposed in the hands of both the state commissioners and the new Federal Insurance Commission on an overlapping, duplicative basis.

Similarly, bifurcation and duplication of regulatory jurisdiction would occur as to state chartered but federally guaranteed insurers. Other state chartered insurers would apparently remain under exclusive state jurisdiction.

The crazy-quilt regulatory patchwork thereby created almost defies orderly analysis. It will envelope the regulators, the regulated and the insuring public alike in a dense fog of uncertainty as to who is responsible and accountable for what.

In the many areas of ambiguity as to boundary lines of authority, Rome could burn while regulators fiddle over who should take the first step: the appropriate state official or the Federal Insurance Commission. Likewise, in areas of duplicative or overlapping authority, both levels of regulatory officialdom may again hold back and wait for the other to move, especially in a "hot potato" type situation. Or, if both do assert jurisdiction, the result will be wasteful duplication of efforts, or even worse, the imposition of inconsistent or conflicting mandates or standards on the person or company regulated. The end result could have a stultifying, paralyzing effect on the whole regulatory process. The consuming public stands to lose the most when this occurs.

(4) The system created by S-1710 will be unduly costly, wasteful and inefficient.

For the reasons just cited plus other attributes of the measure, the system S-1710 would create will be unduly costly, wasteful, and inefficient.

A complete list of even the readily discernible instances of duplicative features, unjustifiably costly requirements, ambiguous provisions, and other undesirable features would indeed be a long one. Here is a partial summary of those we have observed in our reading of the bill:

Just on the face of the bill without attempting to foretell what regulations might be expected from the Federal Insurance Commission, we see at least the following vital areas of regulation of federally chartered companies as duplicative or conflicting at the state and federal level: Discrimination standards; solvency standards and liquidation laws; financial reports, company examinations; holding company activities; and mergers and consolidations. State chartered but federally guaranteed companies will be subject to duplicative regulation for licensing standards (including capital and surplus requirements), standards for computing and maintaining reserves and investment standards, plus the areas just listed for federally chartered insurers.

The cost of insurance regulation (which must be borne by the public) will thereby increase greatly -- as much as two-fold -- because of the superfluous layer of wasteful bureaucracy S-1710 will create. For this added burden the public will receive nothing in benefits.

Special mention should be made in this connection of company examinations. The states are now devoting tremendous resources and employing a host of skilled, experienced personnel to a continuous process of comprehensive,

penetrating examinations of all companies, with emphasis on those needing the closest scrutiny. That vital process has been repeatedly strengthened and improved by the states. Working through the National Association of Insurance Commissioners, the states have exposed the process to the critical, expert scrutiny of recognised outside consulting and research organisations, and have been far ahead of certain federal agencies in developing and adopting effective early warning systems and other valuable mechanisms and procedures recommended by those studies.

Attempted federal duplication of these highly effective functions now being capably performed by the states would accomplish nothing but confusion, waste and added costs for the consuming public.

Another major feature of S-1710 which will bring tremendous added costs and burdens without commensurate added benefits is the proposed new Federal Insurance Guaranty Fund. This Fund will cover all lines of insurance. It will reimburse all claims and all elements of claims (including unearned premium) without restrictions.

While it may seem socially appealing to want to pay every dollar of every type claim in the event of an insolvency, someone must in turn pay the bill. Ultimately that someone is the insuring public.

State guaranty funds have wisely excluded some of the large commercial lines of insurance both as a necessary economy measure and because the purchasers of this type of insurance are usually sophisticated buyers of insurance. They are in a better position than purchasers of personal lines coverage to evaluate the financial stability of a company. Commercial enterprises are also generally able to in effect self-insure against any losses resulting from an insolvency.

Unearned premium claims are also often excluded under state guaranty funds because they are not true "insurance losses", and they are normally very small. Many state guaranty funds utilize a deductible (a maximum of \$100 or \$200) simply because it is impractical and inordinately expensive to process these small claims. The state guaranty funds have recognized that the public cannot afford to pay the total cost of every insolvency. Certain types of claims have been given priority so that the people who need funds the most will have their claims paid in a timely and efficient manner.

Another danger lurking in the proposed federal insurance guaranty fund is the prospect of regional subsidization. Some states have had no insolvencies at all, and some others have only been minimally affected by insolvencies. On the other hand, certain states have been faced with insolvencies which required the guaranty funds to hire full time professional staff and the insurance departments to establish large liquidation bureaus. Why should states which have had very good experience in the insolvency area be forced to subsidize other states with poor experience? Under S-1710 there is nothing to foreclose this very real danger.

The pre-assessment aspect of the Federal proposal also creates serious problems. Insurers will be assessed one-fourth of one percent of their annual premium volume to establish a fund to pay for future insolvencies. There is no cap on accumulations in this fund -- just a vague proviso which would allow the FIC to cut it off whenever it felt like it. If history tells us anything, we can expect this fund to reach a multi-billion dollar figure within a few years. This will deprive our industry of surplus needed to accommodate expanding markets. For every dollar added to surplus, it enables a company to write three or four more dollars in premium. If these dollars are diverted from company surplus, capacity suffers accordingly.

Under Section 103 the Commission has authority to revoke a guaranty certificate of a state chartered insurer when such insurer's financial condition would have justified a denial of the certificate in the first place. This provision can be interpreted to permit the Federal Guaranty Fund to elect to insure only those companies which are in robust financial shape and then at the first sign of trouble, toss a company back to the state regulators and state insolvency funds. If so, then the proposed Fund is indeed of limited value.

Once a certificate has been revoked, does this mean the state fund is automatically on the hook for coverage? Or will there be a gap in coverage? There is a provision continuing the federal guaranty coverage until the policy is either renewed or cancelled, but what happens if (as is often the case) the policyholders cannot find new coverage by the end of this period?

As a practical matter, once a federal certificate is revoked under S-1710, the state of domicile may be forced to liquidate the company immediately to avoid any new liability arising under its own guaranty fund. This could force the liquidation of many companies which are experiencing some financial difficulty, but are far from the point where liquidation would otherwise be justified.

Also, pertinent to this same subject are these four questions:

First, Section 104 provides that the Commission shall pay any valid guaranteed claim through other insurers to which policies have been assigned. Does this mean that companies will have to aid in the administration of the Guaranty Fund by running off the business at the expense of their policyholders? Or what does it mean?

Secondly, will the liquidation acts of the various states apply to Federal Guaranty Fund insolvencies when the company is not federally chartered or are those acts preempted?

Thirdly, if an insurer is dissolved under the federal bankruptcy laws, one would assume the priority of claims provided in those laws would apply, but Section 104(b) provides the Commission shall have a claim against the liquidator for amounts paid from the Federal Guaranty Fund and the normal distribution under state law will apply. This also raises the question of which state law for a federally chartered insurer will apply.

Fourthly, Section 106(c) provides that the Commission may apply to the Court to have an insurer's charter revoked, but the receiver appointed under Section 106 (a) may intervene if it disagrees with the determination of the Commission in this matter. But the receiver appointed under (a) is the same Commission which also makes the determination of whether to apply for revocation under (c). It seems as though the interests of the insurer are not being well protected here.

Aside from the guaranty fund provisions, there are many other provisions and features of S-1710 which are confusing, ambiguous or otherwise objectionable.

Thus, Section 107(c) on discrimination poses some vexing questions for federally guaranteed insurers.

Would the fact that some companies restrict their writings to farmers be treated as unfairly discriminating with respect to urban dwellers, when such companies simply do not write business in urban areas? And also, is there a conflict between 107(c) and Sections 109 and 204 dealing respectively with competition and the Federal chartered companies exemption from state rate regulation? Could Section 107(c) be construed as creating a system of rate regulation?

The investment provisions of the bill are equally troublesome. They would turn over to a single federal agency virtual control over investments of federally chartered insurers. They would also grant unlimited

discretion to the FIC to disallow investments not meeting the vague, if not indefinable, statutory test of "unquestioned integrity and stability". Thus, control over the investment decisions for what could aggregate billions of dollars with respect to federally chartered insurers would be transferred to a federal agency.

Even more damaging could be the indirect control the FIC would wield over the investment policy of federally guaranteed state chartered insurers. Although the bill purports to leave authority for regulating investments of these insurers with the states, it negates this intent by authorizing the FIC to determine that the particular state investment laws do not provide for investments in assets of "sufficient integrity and stability". Every state regulator therefore will have the FIC second-guessing his actions and those of his legislature with respect to investment policy for state chartered insurers. Ultimately, a national norm could likely arise for almost all investments, dictated by a single federal agency, under the blank-check standard of "unquestioned integrity and stability".

Many other grants of authority to the Commission are so broad and so vague as to permit regulation by fiat. The bill at various points arms the Commission with sweeping powers and controls over the most vital of areas affecting insurance company operations, but at the same time is painfully lacking in tangible standards and limitations to govern and guide the exercise of those powers. All too often the only test prescribed is what the Commission itself deems necessary or reasonable, which of course is no test at all.

S-1710 therefore has built into it all the ingredients for creation and expansion of a powerful, costly federal bureaucracy of virtually unlimited power and authority.

(5) The banking regulatory system which has been cited as a precedent for S-1710 provides an inappropriate and unconvincing example.

When Senator Brooke introduced S-1710 he commented that his proposal "would seek to improve the quality of insurance company regulation by providing for an alternative system of Federal regulation similar to the Federal regulatory alternative presently available to banks and savings and loan associations under what has come to be known as the 'dual banking system' ". Inherent in this statement is the assumption that the insurance industry and the banking industries are parallel in nature and the quality of regulation of banks is superior to that of insurers. We disagree with both assumptions. We also disagree with any suggestion that S-1710 is really an alternative system similar to the present banking regulation system.

The basic nature and function, as well as the economic structure, the competitive and market makeup, the pricing, product and classification concepts and problems, and other basic characteristics of the insurance business are fundamentally different from those of banking, and have always called for a markedly different regulatory system.

The banking system provides the mechanism for personal savings, borrowing and lending. Property/casualty insurance companies, on the other hand, are providing a service--a promise to indemnify--given the occurrence of certain events. Among other things this difference becomes significant when

viewing the interaction of rate and solvency regulation. Regulation Q allows banks a fixed ceiling on costs; insurance loss components such as hospital room charges, physicians fees, medical supplies and automobile crash part prices are not controlled in any way.

Previously, at pages 5-10, we showed that S-1710 would actually afford only the very large insurers a real choice and that their choosing federal chartering would give them a crushing competitive advantage over small companies, first, by depriving small companies of the broadly-based experience data and other rating information they vitally need, and second, by achieving almost total pricing freedom while leaving the small companies subject to the strictures of state rate controls. We know of nothing in the nature and make-up of the banking industry or in the interplay between existing federal and state banking regulatory requirements which has enabled or would enable big business to so eliminate small businesses. It is therefore highly inaccurate to cite the existing banking regulatory systems as a precedent for adoption of S-1710.

Any attempt to base a case for S-1710 on the insolvency issue must also fail. The problem of insurance insolvencies is relatively small, is diminishing, and is being very adequately dealt with by state regulators and state insolvency funds. Only 8 companies were ordered liquidated in the last 20 months and most of those were so small they had very little impact.

This healthy picture does not bear a shadow of resemblance to the emergency of the great depression, when 9,100 American banks failed. It was out of this catastrophe that the FDIC was born. No corresponding need exists for a Federal Insurance Guaranty Fund.

Judging from past experience, the size of the federal fund which the insurance industry would be required to accumulate would be huge -- perhaps ultimately comparable in magnitude to the \$7.3 billion surplus fund which the FDIC has developed. It would be the worst imaginable form of "overkill" to create such a behemoth to cover 8 small liquidations which are already adequately covered.

Nor does the actual record of the Federal system for the regulation of banks indicate that that system is so effective and problem-free as to commend itself as a precedent for application to the insurance business. Items such as the following indicate that the dual system of regulation employed there is exhibiting many weaknesses and requiring considerable remedial attention:

- . The promulgation of burdensome regulations (such as Regulation Q) which have failed to accomplish their intended objectives while creating additional costs and bureaucratic red tape.
- . The imposition of regulations which by design manipulate competition by restricting ease of market entry, merger and branching, without producing any substantive benefit to depositors.
- . The repeated allegations that one regulatory agency, the Federal Reserve, has attempted to satisfy its growth aspirations by "persuading" banks to become members.
- . The publication of a critical report of the bank regulatory system by yet another Federal agency -- the General Accounting Office.
- . The fact that the largest number of bank failures to occur in a single year, and the eight largest bank failures in FDIC history, have occurred during the last five years -- a period in which the regulatory system was supposed to have become more refined and more sophisticated.
- . The trend of relatively larger banks joining smaller banks in withdrawing from the Federal Reserve System apparently in an attempt to seek more responsive regulation.

- **Proposals in the last Congress to establish a monolithic, super-bureaucracy -- the Federal Bank Examination Council -- to coordinate the activities of the regulatory components of the dual system.**
- **Revelations by persons experienced in defrauding banks that because state and federal banks are under different governmental supervision it is easier to move illegal loans from one bank to another without detection. (U.S. News and World Report, 9/12/77)**
- **The announcement on the first of this month that the FDIC has authorized a major study of the existing systems of commercial bank regulation "with a view to reducing regulatory costs and needless red tape" -- including a pinpointing of "the extent of duplication and conflict that actually exists".**

Nor has the price tag for dual regulation of banks come cheap. The three main banking regulatory authorities (i. e., FDIC, Federal Reserve and Office of the Comptroller of the Currency) have a combined annual budget exceeding \$200 million and a staff of over 8,000 employees. These figures may give us some "ball park" index of the additional costs that might be added to the existing costs of state regulation of insurance, given the dual system proposed by S-1710.

(6) Enactment of S-1710 is unneeded and unwarranted because the state insurance regulatory systems have proven fully responsive to the public needs by promoting competition and solvency, fostering product development and innovation, and assuring a constantly expanding market capacity in the insurance business, while the state insolvency guaranty funds obviate any need for a federal fund.

Viewed from a public and consumer interest standpoint, the case for state regulation of our business is far stronger today than it was thirty years ago when the McCarran Act was first adopted. In 1945 Congress was entitled to harbor some doubts about the willingness of major segments of the property/casualty business to forsake widespread monopolistic abuses, or the desire and the ability of many state insurance commissioners to curb such abuses.

It would not have been surprising if Congress had simply preempted control of insurance at that time on the grounds that the states by allowing such abuses to flourish had forfeited their right to regulate in this field. Instead, Congress reaffirmed the right of the states to exercise virtually exclusive regulatory authority over insurance and thereby to render most of the sanctions of the antitrust laws inapplicable.

In doing so, Congress gave recognition to certain unique characteristics of our business which called for a special form of regulation in lieu of a general antitrust approach, including: (1) the crucial importance of solvency, (2) the need for continued close surveillance of insurers' reserves and financial affairs and (3) the practical necessity for insurers to engage in certain forms of joint action in the pricing area. In reaffirming the states' long-standing prerogatives governing our business, Congress further recognized that the states are best able to provide the special form of regulation needed, i. e., that because they are closer to the situs of the insurance transactions they can best protect the multi-faceted interests of the consumer in solvency, price, product and availability.

At the same time, Congress made it clear that it desired certain improvements in the picture that had existed prior to the S. E. U. A. decision. In the House Committee report accompanying the McCarran Act, Congress expressed a desire to "secure adequate regulation and control of the insurance business" and was of the opinion "that competitive rates on a sound financial basis are in the public interest".

The Congressional wish to achieve "adequate regulation and control of the insurance business" must clearly have been satisfied by the overwhelming response evoked from the state legislatures and insurance departments. The network of laws and regulations adopted in the wake of the McCarran Act comprehensively cover every phase of property/casualty insurance operations. Nor has the state legislative/regulatory picture remained static since the massive wave of action in the immediate post-McCarran period: The states have continued to make timely response to new problems and needs as they have arisen during the ensuing years.

The property/casualty business that has developed and emerged under this system not only has satisfied the Congressional desire for "competitive rates on a sound financial basis", but it also meets other basic economic tests of a competitive industry.

The monopolistic practices that characterized the pre-McCarran Act era have long since been eliminated. The power of rating organizations to stifle independent pricing and force adherence to their rate levels has disappeared, and their role has more and more become essentially advisory. Gone, too, are the restrictive practices of pre-S. E. U. A. producer groups which denied innovative companies access to important markets. The tide has shifted sharply, as direct writers and exclusive agency companies have made increasingly deep inroads into those markets.

The aggressive competition provided by these companies has benefited the consumer in at least two ways: First, in the form of the rate savings provided directly by the lower-cost companies to their customers, and, second, through the impact their competition has had on the rates (and the expense component of rates) of others in the industry. This is reflected, for example, in the fact that the average expense portion of the automobile insurance premium dollar for all stock companies dropped from 42¢ in 1943 to less than 28¢ in 1975, a reduction of about 31 percent.

Vigorous competition in pricing has been matched by equally aggressive competition and innovation in products and services. Coverages and the packaging of coverages in both the personal lines and commercial fields have been continuously broadened and improved as companies have vied to better meet the changing demands of the consumer. Companies and producers are likewise constantly vying to find better ways to serve the special needs of particular "publics", and thereby increase their market shares.

All these characteristics typify a highly competitive industry.

Another classical economic measure is market concentration. Property/casualty insurance is one of the few industries which can truly be labelled "atomistic". There are more than 2900 licensed property/casualty insurers in the United States. Although many do business in only one state, about 900 operate in all or several states.

Numerous studies have documented that the concentration ratio in our business is quite low as compared to most other industries. The largest writer of property/casualty insurance in the country, State Farm, has less than 7 percent of the market for those lines, and the top 20 groups account for less than 54 percent of the market.

Ease of entry by new entrepreneurs is also recognized by economists as a key element in existence and maintenance of a competitive market. Here again, numerous studies agree that entry into property/casualty insurance market has been relatively easy, that there has been a healthy influx of new companies in recent decades (353 new companies entered the market between 1967 and 1976), and that those periods when the influx has slowed are attributable to drops in profitability rather than to entry barriers.

Still another test of competitiveness is profitability. If overall profits were found to be inordinately high, it could indicate that there has been a dearth of competition which has permitted maintenance of artificially high price levels. Exactly the opposite is the case here: The profit record of property/casualty companies as a whole, when measured by formulae applied by recognized economists, has remained well below that of other industries in our economy, reflecting in large part the impact of competition.

In spite of below-par earnings, our industry has managed to provide the increased capacity required to meet the expanding insurance needs of a rapidly growing population and an exploding economy. This fact denotes that our business is not only competitive and progressive but highly efficient as well.

Where there have been problems, the states have quickly responded to the challenge with new and innovative regulatory approaches to assure a proper solution for the public but retain a viable industry for the future. When, for example, the medical malpractice problem surfaced, improvements in the tort/insurance system were developed and put into practice almost immediately. The same damage award spiral has created availability pressures in products liability and other professional liability lines that state regulators and the insurance industry have again responded to with direct and practical measures.

As already noted, state regulation for solvency and protection of policyholders and the public is another crucially important area that has been capably dealt with over the years. First, states have continually improved regulation and financial standards of companies. Subsequently, property/liability funds now the law in 48 states and the District of Columbia and Puerto Rico were established to further protect the public.

The National Association of Insurance Commissioners has been working constantly to improve state insurance department techniques. Increased regulation for solvency including careful review of management and financial resources before company licensing, together with continuous surveillance over company operations through early warning techniques and refined examination procedures is just part of this never-ending effort to improve regulation.

The NAIC early warning tests were developed and implemented by the prestigious firm of McKinsey & Company which was retained as a consultant to the NAIC to make more effective and efficient the NAIC examination system.

The tests have been operational for about five years. The results are used to identify companies which may be experiencing financial difficulties. The results of these "priority" companies as well as all other companies are transmitted to the various state insurance departments for use by the Commissioners together with other factors to determine the urgency of an examination for a particular company. The tests have proven to be an extremely useful tool in regulating for solvency.

Every insurer must file an annual financial report detailing its current financial status and summarizing the financial activity for the past year and is subject to an examination at least every three years in their own domestic states. These examinations are often supplemented by NAIC Zone examinations. Insurers are examined more frequently when the early warning tests would so indicate.

This elaborate system of regulation for solvency virtually eliminates the possibility of a jumbo insolvency with a large deficit in assets. Most large insurers are licensed in almost every state. The Commissioner in each state has a watchful eye for solvency problems. If the early warning tests detect financial difficulty, there is ample time for remedial relief before the deficiency becomes insurmountable. Each state acts as a check and balance against the others.

There is a flexibility in the present system that has been extremely beneficial for the public over the years. Regulators in various states have dealt innovatively and successfully with financial problems of companies. In many instances, companies have been pulled from the brink of disaster by alert regulators who have obtained refinancing or other help that was impossible otherwise. The GEICO matter is a prime example of swift regulatory action by an alert Commissioner. Here the capabilities of the industry were called upon to help in providing the necessary financing to ward off serious difficulties. The response generated was sufficient to solve the problem at very little cost to the public.

Part of the untold story about GEICO is the personal commitment the domiciliary commissioner, Superintendent Wallach, made and carried out to save GEICO. He made it first order of business to save policyholders and claimants and other insurance companies in his jurisdiction from the losses and burdens a GEICO insolvency would cause. We are fearful that this type of personal dedication to service will be swallowed up and lost in the atmosphere of confusion, uncertainty and divided responsibilities that S-1710 will create. Federal regulators sitting in Washington are too far removed not only from the industry they regulate, but more importantly, from the people that industry serves.

It is an amazing anomaly that supporters of S-1710 have pointed to the rescue of GEICO, a crowning achievement under our present system, as a reason for change to a system where such rescue would probably never have transpired.

In the administration of the state guaranty funds, a very effective and inexpensive program has been developed to protect the public. The funds are managed by local governing boards drawn from insurance companies. This keeps the amount of paid staff to a minimum.

Acting in an advisory capacity to the state funds is the National Committee on Insurance Guaranty Funds, a voluntary organization supported by the insurance business. NCIGF helps develop new techniques and procedures for improving the operations of guaranty funds. It sponsors periodic seminars for guaranty fund board members and fund managers to bring them up to date on the latest innovations and to provide them a forum for discussing and solving common problems. The NCIGF has also made recommendations to the NAIC, which have been approved, providing for improvements to the original model act to help solve multi-jurisdictional problems experienced in a multi-state insolvency.

The response by the states to the insolvency problem has not remained static. There is a constant ongoing study by the NAIC, the legislatures and the industry to fine tune our existing system. Some areas currently being developed by the NAIC include: a model rehabilitation and liquidation act;

new proposals for financing examinations in order to relieve the burden on companies who can least afford it; further development of examiners training to improve examination techniques; and the use of CPA audits to help facilitate the examination process. Another area where fine tuning has taken place is the enactment by states of legislation which amends the liquidation laws to allow guaranty funds immediate access to the assets of an insolvent insurer and a higher priority upon distribution of those assets. Although we feel the existing system of state guaranty funds can handle the insolvency of a major insurer, these amendments will codify procedures available to help facilitate the liquidation process of a large company. Progress in this area has been quite successful with immediate access and priority provisions now law in 17 states (2 additional states have immediate access only), and we anticipate that the other states will soon follow suit.

In sum, the case for continued state jurisdiction over all aspects of the property/casualty insurance business is infinitely stronger than it was 30 years ago. The states have responded comprehensively and meaningfully to the McCarran Act challenge to "regulate". Our business operating within the framework of that comprehensive regulation has emerged as an industry which surpasses most others (including most industries now subject to the antitrust laws) when measured by the classic tests of concentration, ease of entry, and absence of excessive profitability. At the same time, it has been meeting its responsibilities in the marketplace by expanding overall capacity, affording a broad choice of prices, products and services for the consumer, maintaining adequate financial stability and jointly guaranteeing

availability of insurance to all consumers who cannot readily obtain it in the voluntary market.

In the light of all these facts, formidable arguments would be needed to convince us that Congress erred in entrusting insurance regulation to the states, and should now reverse that decision in whole or in part. The burden, we believe, is clearly on those who propose radical change to provide proof that federal regulation of any kind would bring tangible benefits over the states' impressive track record, and would not create onerous new problems. That burden in our opinion has not and cannot be sustained.

Certainly, our business like others faces a host of vexing problems, most of which stem from spiralling inflation in the cost of the ingredients which go into liability and property insurance losses. S-1710 would contribute nothing to the solution of those problems, but would as already noted add substantially to the total operational costs of the insurance system and the regulatory processes.

CONCLUSION

For the reasons cited in this statement, namely:

- S-1710 will substantially repeal the McCarran-Ferguson Act and establish a dual system of regulation;
- S-1710 will not promote, but will destroy competition and eliminate many small businesses;
- S-1710 will deprive consumers of many vital regulatory safeguards, rights and remedies now enjoyed under state law;
- S-1710 will create a system that will be unduly costly, wasteful and inefficient;

- The banking regulatory system cited as a precedent for S-1710 is an inappropriate and unconvincing example;
- S-1710 is unneeded and unwarranted because state insurance regulatory systems have proven fully responsive to the public needs;

we respectfully urge the Committee to reject this measure.

Respectfully submitted,

NATIONAL ASSOCIATION OF
INDEPENDENT INSURERS

BY: Arthur C. Mertz
President

ACM:bjd

The CHAIRMAN. Thank you very much, Mr. Mertz. These were three powerful statements. You certainly don't leave us with any doubt as to the way you stand on this situation.

There is only one sentence I could find in your statement in which you may have been indicating a tendency to favoring Federal regulation, where you say banks are generally a one-State business as opposed to the hundreds of multi-State companies in the insurance industry.

Isn't that an argument in favor of Federal regulation for insurance companies, compared to banks? If banks are a one-State business, they could very well be regulated by the State. The multi-State operations of insurance companies would suggest that Federal regulation might be more logical.

Mr. MERTZ. If one were to rely solely on that distinction between banks and insurance companies, concentrate solely on that, try to make that the big argument, that banks are localized in one State while many insurance companies operate across State lines, the fact that we have many interstate operations, were it the only fact in the picture would indicate maybe the Federal regulation would be needed.

The CHAIRMAN. Senator Brooke documented the case, where the insurance companies domiciled in one State had policyholders in other States that suffered losses and who had no recourse.

Mr. MERTZ. Under the present structure of the State insolvency funds, although there are problems yet to be worked out, they are being worked on right now, both by the NAIC, and by the industry committees operating under their auspices.

There are some problems as far as the handling of losses that cross many State lines. But the bottom line fact is that the policyholders are protected, they are protected, and we say at least as amply in terms of the scope of coverage, as would be the case if S. 1710 were adopted.

And where there are procedural problems or problems of several jurisdictions involved, these have been repeatedly worked out between the States, and we are sure the machinery to enhance that cooperative process will soon be adopted. That is, as to the State insolvency laws, a number of proposals are under consideration.

We have already noted that the early access provisions have been adopted by a large number of States just in the course of the last several years. We really do not believe that the so-called specter of insolvency of interstate operators really is that much of a factor.

The CHAIRMAN. Mr. Mertz, what bothers me about your statement—I think it is an excellent statement, you obviously know this industry infinitely better than I will ever know it, I am a layman in this case, but I have a bias, as most people do, in favor of price competition. That is one of the reasons why our system has worked as well as it has.

You seem to feel that price competition of the kind S. 1710 would encourage and permit, the ending of exemption from the antitrust laws, would be devastating for small businesses, and would be a very destructive, in the long run, of the interests of consumers inasmuch as many competitors would be eliminated.

It would seem to me that the function of the Federal Government, if it moves into this, and the function of the States, too, would be to

see that the insurance companies had ample assets and proper coverage and not excessive liabilities, and so forth, but that their pricing, why can't their pricing be their own business?

Why do you have to have the State fix that aspect which goes to the heart of any business, freedom to compete effectively?

Mr. MERTZ. You don't have to have the States fix the prices, we don't want the States to fix prices, no. We are talking about the State regulatory system that we believe is ideal for the insurance business and the public, which is one that maximizes the forces of price competition, but which, No. 1, establishes standards and boundary lines or channels in which that competition will operate, monitored by the State regulatory commissions and furthermore, second, and highly important, which assures that all of the companies that are competing to the greatest extent possible have an equally fair shake. That is, they all operate under the same rules.

The CHAIRMAN. They certainly don't do that now, do they? They operate under about 50 different rules.

Mr. MERTZ. I am talking about in a particular State, and a particular competitive environment. They do operate under the same rules, yes, because there they are all under one rating law.

I am not saying all of those rating laws are ideal, but all competitors operate under the same rules.

Now the vice in giving an opportunity for insurers to opt to go the Federal route and then exclude themselves from any of the strictures or procedures of the State rating law is that there are many small companies which you might say are disadvantaged companies, in terms of really being able to choose that route and thrive under it. There are many big companies who I believe would be confident that they had a large—

The CHAIRMAN. I hope you are not saying we have to keep the efficient companies' rates high, so that the inefficient companies can stay in business.

Mr. MERTZ. It is not a question of efficiency. I think this is where the Justice Department indicates there may be some confusion there. It is not a question of efficiency versus nonefficiency companies.

The CHAIRMAN. Low-cost companies, then.

Mr. MERTZ. It is not a question of high or low cost companies. What it is a question of is the need, the greater need of some companies for the aggregate industry loss data, experience data, trend data for the future, by which they can chart their course in this very difficult pricing arena, which I think was highlighted yesterday.

You don't know what the product you are selling today is really costing you until years hence. Here is a small company that writes a thousand policies in a given market area. How can it, on the basis of experience generated on those policies, determine not only what the loss experience of the past is, but what the trends are going to be for the future, unless it has available the aggregate data of the industry at large, or a big segment of it?

A big company is not so handicapped. In many of the lines that really count, for instance, automobile insurance, they can paddle their own canoe, they can rate it without having to rely on aggregate industry data.

The CHAIRMAN. Now I would like to ask Mr. Jones, your statement puzzles me. Your statement seems to support many of the consequences of S. 1710, but you don't want to go through it, or pay the price.

What I am talking about is it appears you support the idea of a Federal guaranty fund.

Mr. JONES. Yes, sir.

The CHAIRMAN. To protect against widespread insolvency, but you don't support any of the regulatory or Federal chartering provisions that would be necessary to make that guaranty fund sound.

I don't see how the Federal Government can go about setting up and administering a guaranty fund system without establishing some standards of financial soundness on the part of participating companies.

It seems to me you want the money, but not the discipline necessary in order to make that work.

Mr. JONES. Senator Proxmire, we could support the Magnuson bill today. It had features in it to protect against incompetent managements and unsound handling of investments.

But we think this goes much further than it needs to. We would like to go back to the Magnuson bill.

If I may pull out the investment regulatory features of the bill, we have said there hasn't been a proper distinction made between life insurance companies and property casualty insurance companies.

There may be a case for the investment regulatory features for life insurance companies which are referred to as the long-term industry. I am not saying there is a case, but one might be.

We think they are very inappropriate for property casualty insurance companies and we would like to see a study along that line. We are called the short-term industry in some aspects. Our obligations do not run for the same length of time that the life insurance obligations do.

The CHAIRMAN. Well, I am not sure that I understand that. Maybe I can come back after Senator Brooke on that.

Mr. JONES. I hope we didn't give you the impression that we don't think there is a place for appropriate regulation of companies, both as to the competence of management, the handling of company operations, and the range of investments. We just differed with the particular ones that are here.

The CHAIRMAN. It was just that you seemed to make such a good strong case for the bill, and then you come to the conclusion and said you opposed it. That surprises me. You should conclude therefore we think it is a fine bill, and we support it enthusiastically.

Mr. JONES. It is the form of the bill, the content of the bill. We do think the concept of federally chartered versus State-chartered companies with true options should be explored much more.

The CHAIRMAN. Senator Brooke.

Senator BROOKE. Thank you, Mr. Chairman. Mr. Chairman, if I may take the liberty of summarizing the testimony of the three panelists, first, the American Insurance Association feels that a Federal insurance guaranty program would be desirable, but they do not endorse the bill.

Second, the Alliance of American Insurers is opposed to the bill.

Third, the National Association of Independent Insurers has thrown everything at us but the kitchen sink, and only held back on that because they issue product liability insurance on kitchen sinks [Laughter.]

But having summarized, I do have a few brief questions to ask.

Mr. Jones, I take it you share my concern about the potential problems engendered by postinsolvency assessments?

Mr. JONES. Yes, sir.

Senator BROOKE. Would you care to expand on your prepared remarks in that area?

Mr. JONES. In shortening my statement, I left out a couple of your quotes, but we do agree with them, Senator Brooke.

At one time Senator Proxmire said that we hadn't made a case for the need for a Federal guaranty system, but we almost did. Through the very excellent cooperation of Maximilian Wallach and some of the people in the industry who were competitors in a very great sense with GEICO, we felt the greater part of wisdom was to bring assistance to GEICO, rather than taking it through a totally inadequate insolvency system. They couldn't see a reasonable end to handling all of the claimants and all of the policyholders that would be involved in that process.

If I can go back to 1969 when we supported the Magnuson bill, I recall very clearly the chairman of Fireman's Fund Insurance Co. of California saying he had gone to his management the last time and asked for voluntary contributions on the part of his company to pay the claims of incompetent managements or even dishonest managements. For that reason we wanted to set up a system, and we took as a model the Federal Deposit Insurance Corporation, where we could anticipate this, as an expense of doing business, and we could put it into a fund. There would be some supervision of the companies to protect against the necessity of using the insolvency fund.

Actually what happened was the chairman of Fireman's Fund no longer has the option to ask if his company would contribute to making up deficits of insolvent companies, he has to now under the post-solvency assessment fund in California.

So, it is a case of whether you are going to anticipate insolvencies, having everybody contribute to the fund with a supervision, or not. We were afraid of using the State preinsolvency assessment funds for the simple reason they have been invaded in every State where they have existed. There has been the use of the fund for other purposes, or recently the use of the funds for investments that we didn't think were the soundest in the case of New York State.

Senator BROOKE. I thank you. I am glad that you have expressed your opinion on the GEICO potential. Some witnesses have sort of indicated that—well, I think it is fair to characterize their statements as saying that they want to minimize the potential danger of the GEICO situation. You have not. I think you and I probably agree, we don't believe you have to have a fatality at the corner before you put up a stop sign.

Mr. JONES. We had some major companies that made a great deal of effort to rescue GEICO and they did it because they just couldn't

see themselves facing the alternative. And their agents were not entirely pleased with the fact they chose that course.

Senator BROOKE. Do you think the present State guaranty system could cope with a major company insolvency?

Mr. JONES. No, sir, we do not. It has even been slow in some cases where there were writings in several States.

Senator BROOKE. Mr. Maisonnier, we have received considerable testimony about the uneven quality of State insurance regulations for solvency purposes.

What is your view on that matter?

Mr. MAISONPIERRE. There is no doubt that there is variance among the States in the quality of regulation. But if you look at the States in which most companies are domiciled, you will find that those States have demonstrated exceedingly fine regulatory capacity, particularly over the past decade.

In addition, I think that one area which is so often overlooked is the role being played by the central office of the National Association of Insurance Commissioners, in bringing to individual State commissioners the resources which they as individual commissioners probably would not have. The new early warning system established by NAIC some few years ago, following the McKinsey report certainly is a tremendous new asset and tool for insurance commissioners to regulate for solvency.

And we believe as this system, which you have recognized even in your bill, as this system is further attuned, it will become an extremely efficient system to identify companies which are about to get into trouble before they do get into trouble.

Senator BROOKE. Now you expressed a concern that was also expressed by others regarding the ability of insurers to pool loss data, if they were subject to the antitrust laws. But couldn't we obviate that problem in a bill like this by providing a specific exemption from the antitrust laws for legitimate pooling?

Mr. MAISONPIERRE. Yes; there is no doubt that if McCarran-Ferguson were to be repealed, that one could plow back into Federal legislation certain antitrust immunities which would be necessary for the insurance industry.

Senator BROOKE. Couldn't we grant exemptions? Would you have to repeal the McCarran-Ferguson Act?

Mr. MAISONPIERRE. Yes; there could be a partial repeal of McCarran-Ferguson. The point is this, that the insurance industry and its scope of its responsibilities is kind of a moving target. What is necessary today or what may well be necessary tomorrow may not be envisaged today.

So that one would have to continuously look at the McCarran-Ferguson law to assure that the insurance industry is capable of meeting its obligations. Further, the demands being placed on the industry are usually the demands that must be met within a relatively short time, a time so short as to preclude the ability of legislation review unless it is a major emergency.

Senator BROOKE. Mr. Mertz, the general counsel of one of your member companies, Armour Hank of Nationwide, has produced a paper entitled "Insolvency Reinsurance Proposal, Industry's Alternative to Assessment, State Funds, Federal Regulation."

Are you aware of that?

Mr. MERTZ. Yes, sir.

Senator BROOKE. Would you care to comment on it?

Mr. MERTZ. I can say this has received a great deal of very careful study and is still under careful study not only within our association, but the barebones or broad outlines of it have been made known to the NAIC, or the existence of the proposal, to NAIC and others in industry who are actively working under NAIC auspices on the insolvency problem. It has been studied, it is still on the top of the table.

It presents many formidable problems. At the same time, it has enough interesting aspects to it so that it is being given further study.

Senator BROOKE. Mr. Jones, would you or any others wish to comment on this?

Mr. MERTZ. Before you leave me, sir, I would like to add to something Mr. Maisonpierre said in response to your question about the McCarran Act.

Senator BROOKE. Yes, please.

Mr. MERTZ. At the time of the study by the Justice Department of the question of whether the McCarran Act should be repealed, modified, and so on, those of us in industry—and there was quite a cross-section of industry that was invited in to express their views—expressed to the Justice Department our concern over the very points you raise, and the point we raised here, about the great necessity for certain types of joint activities to be carried on by the insurance industry, not with the idea of restraining trade, but facilitating trade, and also making it possible for all companies, including the smaller ones, to compete.

The Justice Department in the early stages of the study said, "All of the problems you folks around this table are telling us could occur if we amended or repealed the McCarran Act, could they not be solved by simply putting a provision in there to protect you?" So a discussion commenced about how many exceptions you would need. And that discussion went on at great length. I was interested to observe in the report that the Justice Department ultimately put out, and also in Mr. Sims' comments yesterday, that as they studied the problem more and more, the more complicated they found it.

We submitted a very elaborate memorandum to the Justice Department, and in that memorandum we laid out many of these questions as to how you could open up the antitrust laws, or rather eliminate the insurance immunities from the antitrust laws in a large area, and at the same time by language in the McCarran Act repealer protect the things that needed to be protected.

And then, to carry that further, we attached to our memorandum a detailed outline showing step by step how rates are made, the data gathered, analyzed, trends projected, rates, a long list. We said to the Justice Department in the memorandum, "Would you please tell us where you are going to draw the line between what is to be permitted and what is not to be permitted?"

Now, in searching their commentary, they discuss it a great deal, but they have never drawn that line, they have never come forward—and I am not being critical—with any specific statutory language that

they would suggest that could do the kind of thing you are talking about.

And I gather from Mr. Sims' statement that they are no closer to that than they were 6 months or a year ago.

So it is a very difficult problem. The problem is that if you put in all of the exceptions you need to make, you are pretty much back where you are now in the McCarran Act.

Senator BROOKE. Thank you, Mr. Mertz.

Mr. JONES. Senator Brooke, back to the private guaranty funds, we have examined this very extensively over a number of years, and have tried to take various approaches. We tried to take the Securities Investors Protection Corp. as a model and work out a system that way. One of the governors said to us, it seems you need the SEC to make it work with regard to your business. So we had to abandon that effort.

We explored the possibility of State-chartered private guaranty funds. These would have to be voluntary, there is no way around that. Private industry cannot have the power to force other people to come in. The monopoly of power should be placed in government. We had to arrive at the conclusion that the strong and rich would choose to go together in one guaranty fund, and leave the less strong and less rich to self-guarantee themselves voluntarily in other funds.

Then we considered coming in with a Federal chartered privately operated company, but we ran into the same problem.

We are aware of the nationwide proposal, which is similar, except it would be in mutual form, and we are following it, but it is going to suffer from the problem of how you enforce the right of examination. Would insurance companies tell competitors they are not valuing reserves correctly, or not pricing his product accordingly?

We have found it impractical to adopt a private guaranty system.

Mr. MAISONPIERRE. Senator Brooke, we have also examined the nationwide approach, as well as many others that have been proposed. There seems to be a feeling by some people that one can come up with a solution to the insolvency problem which will be a fine solution. We don't think there is a fine solution. We think our alternatives are among undesirable solutions, because we are trying to solve something which is a very unfortunate situation.

We believe that at present the State insolvency system, at least insofar as property and casualty insurance is concerned, is working fairly well, considering the fact that it is a fairly recent system that has been put into operation.

We believe that the States are in the process of moving in the direction of providing the funds with early access to the insolvent company's assets. This, we think, is going to be a major improvement over the present system. It will substantially diminish the assessments made on the companies to pay for insolvencies and we believe it will greatly facilitate the handling of a major insolvent company.

I would like to discuss for a second the GEICO situation. Frankly, I don't think that GEICO today would be a company had there not been a State insolvency system in operation. Essentially, what saved GEICO was the State system.

Sure, the system did not come and provide funds through an assessment procedure. But the State system forced other insurance com-

panies into an action, which in fact has rehabilitated the GEICO company.

I think that is a great plus for the State system.

Senator BROOKE. I won't get into a debate on this, but you and Mr. Jones seem to differ as to what saved GEICO. Mr. Jones thinks it was the private insurers, and you think it was the State guaranty fund. Was it ever insolvent at any time?

Mr. MERTZ. It was never adjudicated; no.

Senator BROOKE. De facto?

Mr. MERTZ. Sir, I think Commissioner Kinder of California indicated that his very able Department's examination of the Company indicated they did not feel the picture was as bleak as many were saying it was.

Senator BROOKE. I do recall that. What that means I am not sure.

Mr. MERTZ. He could perhaps elaborate on it. But I did note that with great interest.

Mr. MAISONPIERRE. Senator Brooke, I believe that the knowledge that the companies would have to come up with an assessment in the eventuality of an insolvency is what forced the companies into going another route.

Now, true, some of the companies may not have been very pleased with what they had to do.

Senator BROOKE. They had to subsidize their competitor and that is not usually the way you do business.

Mr. MAISONPIERRE. They rescued a competitor to the extent rescue was necessary. But this is what would have been done under any insolvency fund, either preassessment or postassessment.

Mr. JONES. I think Mr. Maisonpierre and myself are saying the same thing in different language. He is saying the State postinsolvency assessment system scared the companies into a rescue effort, rather than using the State system.

Senator BROOKE. But the rescuers were the companies, is that correct?

Mr. MERTZ. There is no question. No, I would say maybe not scared, Senator, but the existence of a potential assessment of the State insolvency fund gave those companies that were called in by Superintendent Wallach—and great credit is due to him—it gave those companies a business reason for doing what they did. They have been motivated to do a lot of things in the industry, but every company has to justify—

Senator BROOKE. Out of fear of regulation?

Mr. MERTZ. Well, out of fear of repercussions if this big company collapsed. What I am saying is that alone, had there been no State insolvency funds, that concern alone might have made it difficult for managements to go back to their boards and say "we want to step in here and help GEICO." With insolvency funds, they could say "furthermore, Mr. Board of Directors, if we don't do it, we are liable to get a bigger assessment under the State's assessment fund; let's keep this operation going, because if it collapses the liabilities are going to be many times greater by the time it gets to the liquidators."

Senator BROOKE. We may have a different hearing had it failed.

The CHAIRMAN. We might even pass the Brooke bill.

Senator BROOKE. I don't know if we could go that far.

Mr. MAISONPIERRE. Senator Brooke, I think one of the problems we see under your proposed bill is the following. Let's assume a GEICO situation. I can visualize a number of companies that had decided initially not to participate in the Federal guarantee program, now seeing the potential assessment which they are going to have to pay if the company becomes insolvent, so they immediately apply for and achieve Federal guarantee status. Who then is left at the State level to pick up the insolvencies resulting from such a company?

Senator BROOKE. I don't think that necessarily would follow, frankly. That will take some time. I don't think every company would opt to go into the Federal system, even all of the large companies.

Mr. MAISONPIERRE. It would depend on the size of the insolvency. If the insolvency is large enough, the companies would have to look at the economic advantages. I am afraid there will be a run—

Senator BROOKE. There are advantages to the State system. I just don't think there will be a general exodus from the State to the Federal system. It is purely voluntary, and they will look at it. They don't even have to stay in the system. They can take the option of going with the Federal system and change their minds and come back in the State system.

Mr. MAISONPIERRE. That is a pretty complicated mechanism.

Senator BROOKE. But I am saying it is purely voluntary. There is no mandate.

Mr. MAISONPIERRE. One more thing about the GEICO situation. I doubt very much if any of the companies that participated in the program to strengthen GEICO will lose a penny of the money they invested. I think that they will not lose a penny invested.

Senator BROOKE. I must say to you certainly I am concerned with the GEICO potential. But I am also concerned with the rather huge underwriting loss which could reoccur. What then could happen to policyholders if we did have these insolvencies? They would be in serious condition. I think we made some cases already where policyholders are injured by the present system.

Mr. MAISONPIERRE. With the early warning system being as finely tuned as it is today, we don't believe the GEICO situation would have been allowed to develop under present conditions as far as it did at that time.

Senator BROOKE. My time is up. Thank you, Mr. Chairman.

The CHAIRMAN. Let me ask a couple of questions. Mr. Maisonpierre, I would like to get into another kind of approach. I have been arguing that the insurance situation we have in this country has operated very well, compared to the failure of banks and so forth, and that has been pointed out by other witnesses also, Mr. Jones and Mr. Mertz. The insurance industry has done well.

But the one kind of economic development that I think would be devastating to insurance companies is a terrific rate of inflation over a period of years.

The income of insurance companies is pretty much fixed for long periods. Your investment income tends to be fixed, you are very heavily in fixed obligations. Your premium income is fixed over a long period.

On the other hand, if you have a sudden inflation, your liability losses go up sharply. Whereas the depression was a deflationary period,

that was one of the reasons why insurance companies did relatively well, but a period of terrific inflation that we might very well have in this country—many economists fear that—would put the insurance companies in great difficulty.

The reason I bring this up is because—

Senator BROOKE. It would really affect life.

The CHAIRMAN. It would affect life even worse, but it would affect any product liability, for example.

Mr. JONES. That was part of GEICO. If you go back, they had to make very substantial increases in reserves because of the cost of repairing automobiles in the fourth quarter of 1 year. It was inflation in their obligations of cases pending that threw them suddenly into a very perilous position.

The CHAIRMAN. The reason I raised this problem is because you, Mr. Maisonpierre, said you fear that establishment of a Federal guaranty fund would weaken the State guaranty system by leaving the States with only the weakest companies.

There is some merit in that argument. But other witnesses have argued the insolvency protection should better be afforded at the Federal level, since insurance companies are so big and so widespread that if you really have a serious inflationary development, for example, that many States wouldn't have the reserves, the funds to provide the protection in another series of GEICO's, where as the Federal Government with a national system backing it up would be in a position to provide this.

Mr. MAISONPIERRE. Mr. Chairman, I would agree with you 100 percent, that inflation is extremely detrimental to insurance, particularly property and casualty insurance. To the extent that we have open competition, the companies can charge the rates which they believe are commensurate with the risks being insured, then they can feed into the rate structure some trends, some factors, to take care of future inflationary costs.

The CHAIRMAN. But that takes a while to cure your problem, doesn't it?

Mr. MAISONPIERRE. No; in the costing of insurance, you never cost your product to recoup for past losses. You always cost your product in the anticipation of what the losses are going to be.

The CHAIRMAN. I agree with that. I think that is right, in the long run there is no question that you can come out if you anticipate what kind of inflation you are facing. But if you can't do that, and we don't know what the inflation rate will be—if there is anything the economists have fallen flat on their faces on it is predicting inflation. In 1974 the Council of Economic Advisers was saying it would be 2 percent at the end of the year, and it was 12 percent. It is hard to predict this.

If we are hit with inflation, and we can't anticipate it, then it would seem to me we might have a serious crisis in the insurance industry.

Mr. MAISONPIERRE. We have lived with inflation. We have had inflation. The insurance industry is learning to cope with inflation. I think one of the problems we have today with product liability for instance is that the industry has suddenly realized it is going to be paying losses many years after having collected the premium, and

that the dollar which it will have to use to pay those losses is, the dollar being collected in premiums, will have devalued considerably. Accordingly, the industry has fed into its rating system some factors to compensate for this future loss.

The consumers, the buying public, doesn't recognize there have been some changes in the concept of insurance pricing, recognizing the fact that insurance has to consider future social as well as monetary inflation, and both are very important.

The CHAIRMAN. I understand your response, I think it is the best response you could give under the circumstances. But I still argue that if you can't predict it, and we might have a high rate of inflation that you aren't going to have built into your structure. If you do build it into your premiums, that kind of inflation, and we don't get it, then you will have windfall profits that you would have a lot of complaints about, too.

Mr. MAISONPIERRE. That is right. This is the reason I believe that whatever is built into the rate structure today to account for inflation could still prove to be somewhat inadequate.

Mr. MEERTZ. Senator, one point on that, a small point.

I think that the experience that the industry went through in 1974 and 1975, which was a combination of rampant inflation on the one hand, and a tremendous drop in the securities market, which are not supposed to happen together, was probably the worst set of circumstances—not the very worst, but almost the worst set of circumstances you can imagine for our business. It was, I might add, unprecedented. And it almost you might say approached the impact of the Great Depression on banks, but not quite so much.

The CHAIRMAN. If it had gone on a while longer, and been a greater inflation, you might have had some very serious difficulties in the insurance industry.

Mr. MEERTZ. Indeed, if it had gone on long enough, nothing would have saved it.

But it is important to note our industry weathered that storm.

The CHAIRMAN. That is a good answer. I would like to ask one more question of Mr. Jones.

You say the pattern of State regulation of insurance companies lacks uniformity, and is disappointing, but you oppose Federal regulation, you say that the State regulation could be much improved if more attention were paid to the interstate nature of the insurance business.

Mr. JONES. Right.

The CHAIRMAN. Why wouldn't it be possible, as Senator Brooke argues, that Federal regulation might improve State regulation? It might set a standard, provide a basis for improvement, greater expertise, greater professionalization of your technicians on whom you rely.

The case has been made, and not challenged at all, by a previous witness that the regulators are paid relatively little, and you can't get more competent people in the regulating industry. So why wouldn't it be likely if you established the kind of apparatus that Senator Brooke proposes, the whole process of regulation would be improved?

Mr. JONES. That is a possibility. There have also been questions raised recently about the level of competence in Federal as well as State regulators.

We urged that the committee give further consideration and study to the concept of a truly optional system. We have a number of reasons for that. Some companies are interstate national insurance companies. Yet we readily recognize, Senator, that there are companies that would have no reason whatsoever to be involved with a Federal regulatory system.

There are 8,300 property casualty insurance companies in the country. A. M. Best Co. keeps track of 1,850. There are a lot of fine reliable local mutual fire insurance companies around the country. You can drive through upstate New York and find New Berlin Mutual Fire Insurance Co. They insure property losses in their area, and are very difficult to compete against, because they have low operating costs.

The concept should be explored more. If I could go back to one of your statements—something may happen right after this testimony—we do think that our industry has a very fine record of performance in the financial community. Relatively speaking, we have had fewer scandals than might be in other industries. We have experienced Equity Funding and others, but we think there is a fine record in this industry, and that was the reason we were concerned about the extent of regulation Senator Brooke seemed to feel was necessary in S. 1710.

I think that is what needs to be reviewed and reevaluated.

The CHAIRMAN. Thank you. Senator Brooke.

Senator BROOKE. I have no further questions. I again want to thank this panel, I think they have really contributed. I think it is going to be an excellent record.

The CHAIRMAN. It has been a very, very good panel. Thank you, gentlemen, very much.

The committee will recess until 9:30 tomorrow morning.

[Thereupon, at 12:50 p.m. the hearing was recessed, to reconvene at 9:30 a.m. the following day.]

[The following letter was received for the record:]

AMERICAN INSURANCE ASSOCIATION,
Washington, D.C., October 19, 1971.

HON. EDWARD W. BROOKE,
Russell Office Building, U.S. Senate,
Washington, D.C.

DEAR SENATOR BROOKE: As a supplement to the testimony of our President T. Lawrence Jones before the Committee on Banking, Housing & Urban Affairs September 13, 1977, we submit the following comments on the investment and tax provisions of S. 1710 for your consideration. We approach this bill with your admonition in mind that it is a working document to be studied and criticized.

The preamble to the Federal Insurance Act states:

"The United States national policy shall be to facilitate early detection of the financial condition of insurers which, if not corrected, render reasonably probable the insolvency, impairment or inability of such insurers to fulfill their contractual obligations to policyholders or claimants when due, and to provide for the orderly winding down and liquidation of insolvent insurers by establishing a Federal insurance guaranty program which shall establish uniform standards for guaranty status and shall maximize the efficient utilization of the capabilities and facilities of private insurers in the discharge of policy obligations of private insurers in the discharge of policy obligations of private insurers which become insolvent [§ 102(a)]."

Assuming one could accept this premise, over which the hearings produced substantial disagreement, it is difficult to understand why the pervasive scheme of investment regulation in S. 1710 is necessary, or why the subject of retaliatory state taxation for property-casualty insurers is relevant or material.

In the case of a Federally chartered insurer, the Federal Insurance Commission would be given power to disallow any investment which supports policyholder obligations and minimum capital and surplus if it fails to meet the standard of "integrity and stability." This standard has no precedent, except in a recent amendment to South Carolina law. The Federal Insurance Commission would be free to interpret its meaning much in the same way as the Federal Trade Commission (FTC) decides what is an "unfair trade practice." The fact the standard in S. 1710 has little relationship to previous regulation of insurance investments at the state level may give the new Commission wider latitude than FTC enjoys.

Even though the bill is presented as an option, which theoretically would allow insurers to remain regulated by the states, S.1710 would bring to bear a powerful Federal presence on the way investments are regulated at the state level for any company which wishes Federal guaranty protection without a Federal charter. In evaluating applicants for a Federal guaranty certificate, the Commission is directed to "make such examination . . . as it deems necessary to ascertain . . . [its] financial condition and fitness. For this purpose, the Commission may utilize [its] employees . . . , independent contractors, and other agencies of the Federal Government. It may take into consideration reports of independent auditors and reports and certifications by State supervisory authorities [§ 103(d)]. The bill repeats a provision from S.3884: "Any person exercising or possessing effective control of a federally guaranteed insurer shall be subject to the regulatory authority of the Commission" [§103(e)].

The Commission may refuse to issue a certificate upon determining an insurer "is not financially safe and sound for any, or any combination of . . . reasons," the first of which being "assets supportive of the insurer's policyholder obligations fail to provide sufficient integrity and stability for that purpose" [§103(h)(1)(B)(1)].

Investments of a federally guaranteed insurer, other than a federally chartered insurer, shall be regulated, in general, by the laws and regulations of . . . [the] State of domicile and . . . States in which it transacts insurance unless the Commission shall determine, after hearing, that the laws or regulations of such State or States fail to require that the minimum policyholders' surplus and reserve liabilities, including the loss reserves, unearned premium reserve, and mortality and morbidity reserve . . . be covered, to a reasonable degree, by admissible assets of sufficient integrity and stability . . . Upon making such findings, the Commission shall issue such order as is necessary to bring the insurer's investments into compliance . . . or to terminate its status as a federally guaranteed insurer . . . The Commission is authorized to issue a subpoena requiring the insolvent insurer to furnish such books, records, or other materials [§103(j)]. The degree of control which the Commission would possess over non-chartered federally guaranteed insurers may be more strict, even though indirect, than the direct control it would possess over federally chartered insurers. In non-chartered companies, minimum policyholders' surplus and reserve liabilities must be covered by admitted assets, to a reasonable degree, "of sufficient integrity and stability." There is no basket of 30% policyholders surplus cut into this requirement. For Federally chartered insurers, only policyholders obligations plus minimum capital and surplus must be covered by assets of integrity and stability. The full implications of this distinction are difficult to weigh.

The philosophy underlying the pervasive regulation of invested assets in S.1710 appears to assume an insurer must be able to pay all of its policyholders obligations simultaneously, or within a very short span. Insolvencies do not occur in this manner. Outstanding obligations mature in the regular course of business. Insurers collect policyholder funds in advance for distribution in claims at a later date. As long as an insurer enjoys a positive cash flow it will be able to meet policyholder obligations even though the value of liabilities at a given time may exceed the value of assets. We believe the attempt in S.1710 to limit investment risks rigidly by law would accelerate the danger of insolvency by removing management's ability to relate investments to different risks associated with the varying mix of business written by each insurance company, and to respond rapidly to changing conditions in our complex economy.

Containing investment risk alone is meaningless in protecting policyholders adequately against insolvency. Underwriting risk must also be considered. No more than one percent of recent insolvencies may be attributed to investment losses. The predominant causes of insurance insolvencies have been underwriting losses and dishonest management. A more relevant means of accomplishing

the national policy enunciated in S. 1710 would be to establish an effective early warning system which operates under the concept of "multivariate discriminant analysis." We are currently discussing the desirability of an early warning system geared to "multivariate discriminant analysis" with the National Association of Insurance Commissioners (NAIC).

Section 204(b) of S. 1710 states:

"Nothing in this section may be constructed to deny to any State the right to levy taxes or to require license fees for federally chartered insurers . . . except that a federally chartered insurer has no liability to any State for a tax measured by gross premiums or net premiums collected to the extent that the amount . . . exceeds . . . the amount which would be imposed on the same amount of gross or net premiums of the least taxed insurer . . . doing the same type of business and organized under the laws of any State. . . . Except as otherwise provided herein, a federally chartered insurer shall for tax purposes be taxed at no higher rate than a foreign insurer doing the same type of business in any State in which it is authorized to do business."

We have explored carefully the way in which section 204(b) would impact state taxation of property-casualty insurers, and have discovered little, if any, benefit. Clearly it would not eliminate all retaliatory state taxes. Many retaliatory taxes are not measured by premiums. A State could continue under S. 1710 to charge domestic insurers a higher or lower rate of taxation than would be charged federally chartered insurers operating in the same State. States would also be able to continue offering domestic insurers lower tax rates than foreign insurers which compete in the domestic insurer's home state. Because the effect of section 204(b) is equivocal, it might cause States to raise the rate of taxation on all property-casualty insurers to compensate for expected revenue losses, without offering any appreciable relief to insurance companies. On balance, our members believe the existing State system of taxation is working. We are apprehensive that an attempt in S. 1710 to explore this subject may cause States to increase the level of taxation. The fear by the States of losing revenue from taxation of insurance companies as a result of the *Southeast Underwriters* decision was the principal reason Congress enacted the McCarran-Ferguson Act. Section 204(b), taken in context with other provisions in S. 1710, raises obliquely many questions about the current taxation of insurers under the Internal Revenue Code. This would almost certainly invoke the jurisdiction of the Senate Finance Committee and the House Ways and Means Committee. We respectfully suggest section 204(b) is not relevant or material to the fundamental objectives of S. 1710, and should be deleted. We firmly believe the Federal Insurance Act should take no action, directly or indirectly, which would affect the existing method of taxing property-casualty insurers at the State level, or under the Internal Revenue Code.

Our more specific concerns regarding S. 1710 are stated below:

1. No distinction is made between life, health or property-casualty insurance. Investments by all insurance companies would be regulated in common by Section 205 of S. 1710. Traditional distinctions between the appropriateness of various categories of investments for different insurance functions are ignored generally. The evolutionary way these distinctions have developed at the state level is disregarded. Limited recognition of the need for such distinctions may be found in subsection 205(c)(12), (13) and (14) which permit life companies to invest assets supporting policyholder obligations in loans to policyholders who pledge their policy as collateral, and in bonds or notes secured by certain classes of real property, or insured by the U.S. Government.

The tendency to look upon life, health and property-casualty insurance as one industry which should be regulated in the same manner appears also in the approach towards issuing a Federal charter:

"In the case of a group or fleet of insurers under common management or subject to the effective control of one person, including, but not limited to, a holding company, no one or more of such insurers (other than alien insurers) constituting such group or fleet of insurers or insurers under common management or control shall be chartered unless all be so chartered or a plan for such chartering is filed with the Commission for its approval [208(a)(8)]."

It is difficult to understand why all life/health companies under common control or management, or all property-casualty companies under common control or management would not be eligible for a Federal charter regardless of whether other types of insurance companies under the same management or control are chartered at the Federal level.

2. S. 1710 would not allow assets supporting policy holders obligations to be invested in 21 categories of investments which are now permitted under state law as reserve investments:

- (a) Noncorporate net leases,
- (b) Trustee and receiver obligations,
- (c) Equipment trust obligations,
- (d) Production payments,
- (e) Acceptances and bills of exchange,
- (f) Mortgage loans,
- (g) Real estate
- (h) Foreign investments,
- (i) Stock and debt of housing companies and corporations acquiring income producing property,
- (j) Obligations issued or guaranteed by the International Bank for Reconstruction & Development, the Inter-American Development Bank, or the Asian Development Bank,
- (k) Obligations guaranteed by the community facilities project guarantee fund,
- (l) Stock and obligations of mortgage companies,
- (m) Transportation equipment,
- (n) Personal property,
- (o) Real estate corporation stock,
- (p) Stock in subsidiaries,
- (q) obligations of Canadian municipalities and agencies (S. 1710 mentions only the Dominion of Canada and its Provinces),
- (r) Securities traded in the United States and issued by foreign corporations, e.g., Schlumberger, Royal Dutch/Shell.
- (s) Securities traded over-the-counter,
- (t) Hospital revenue, industrial revenue, and pollution control obligations. It is unclear whether they would be deemed "issued, assumed, or guaranteed by any county, city, town or district of any such State" in subsection 8(c)(8), and
- (u) Municipal obligations payable from conditional sales or lease payments.

Each of the above categories is specifically allowed by New York insurance law for reserves. The New York statute is regarded as the most restrictive state law governing insurance investments. It also can apply extraterritoriality to investments held by any company licensed to sell insurance in New York State, regardless of where the company may be domiciled.

The potential which S. 1710 may have for disrupting the investment practices of insurance companies, and the implication this could have for the ability of each category of issuer named above to obtain debt or equity capital cannot be underestimated. This possibility is particularly alarming because of the power which S. 1710 would grant the Federal Insurance Commission to regulate indirectly investments of state chartered insurers which seek Federal insolvency protection.

3. S. 1710 would introduce an untested, vague standard by which insurance investments could be disallowed.

Assets supporting policyholder obligations plus minimum capital and surplus shall be invested according to a standard of "integrity and stability" in S. 1710. This standard, as well as the entirety of Section 205, is a copy of Section 37-195 of the South Carolina Insurance Code, as amended in 1971. As far as we can determine there have been no subsequent interpretations or case law in South Carolina to shed light on what those words mean. The standard of "integrity and stability" exists nowhere else in state regulation of insurance investments, to our knowledge. The Federal Insurance Commission would seem free to give those words any meaning it wishes in deciding to disallow any specific investment which supports policyholders obligations plus minimum capital and surplus. This standard might prevent purchasing any bond except one rated triple A. The word "stability" could imply investments would be allowed only in short-term obligations.

The problems which a new standard for judging investment management can create are shown by modification of the prudent man rule in ERISA. S. 1710 could create larger problems than ERISA because ERISA retains to a considerable extent language interpreted by courts for decades in deciding cases under the "prudent man" concept.

Contemporary portfolio theory, however, has a more complex view of the riskiness of an investment portfolio than traditional trust law, which has a virtually

exclusive focus on the possibility of capital loss. This change in the view of risk has been accompanied by the realization that each investment should be evaluated in the context of the entire portfolio, rather than on an individual basis, as was the rule at common law. The statutes, however, do not reflect this change. Rather than clearing the air, ERISA requires fiduciaries to discharge their duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." Neither ERISA nor its legislative history clearly indicates how any of the other standards which might be implied in the statute are to be interpreted in conjunction with the prudent man standard above. When evaluating trustees' investment decisions under the prudent man rubric, most courts focus on the possibility of capital loss as the sole measure of the riskiness of an investment. Moreover, each investment is evaluated in isolation from the portfolio of which it is a part. The portfolio is considered as a whole only in the requirement that it be sufficiently diversified to minimize the risk of loss. Through all of its stages of development, the common law has been shaped by the need to resolve the basic tension between the interests of the income beneficiary and the remainderman of a trust, giving greater weight to the remainderman's interest by valuing safety of the corpus over generation of income.

In the view of Senator Lloyd Bentsen and other members of the Senate Finance Committee, the adoption of the prudent man rule in ERISA has made pension fund managers afraid to purchase any stocks for their managed portfolios except those of the highest rated Fortune 500 companies. As a consequence, many smaller corporations believe they have been foreclosed from equity markets because of ERISA's adoption of the prudent man rule. Senator Charles Mathias has introduced legislation to amend the prudence requirement in ERISA so as to permit sound investment strategies designed to take into account the impact of such economic forces as inflation, and the soundness and growth potential of total investments rather than on an investment-by-investment basis.

4. The "basket" provision in S. 1710, intended to give flexibility beyond the standard of "integrity and stability" for insurance investments, is drafted in such a way that its actual effect upon investment portfolios cannot be determined.

Under the most favorable interpretation, section 205 in S. 1710 may contain a more liberal "basket" provision allowing investment discretion than New York State law. Your legislation provides:

"[E]very federally chartered insurer shall have and maintain investments of the classes described . . . to the extent of policyholder obligations and minimum capital and surplus . . . less an amount equal to 30 percent of its surplus as regards policyholders, but in no event shall such insurer have and maintain investments of the amount described less than in an amount equal to the sum of 70 percent of such policyholder obligations . . . and 100 percent of the minimum required capital and surplus, except that the investments referred to in this subsection shall be subject to the limitations provided by subsection (d)."

We are told the intent is for "less an amount equal to 30 percent of its surplus as regards policyholders" to be a basket for any type of investment not allowed in subsection 8(d). Under that approach, the specific categories enumerated in section two of this report could fall within the basket. If a figure equal to the sum of 70 percent of policyholder obligations and 100 percent of minimum capital and surplus is greater than 30 percent of policyholders surplus, then an insurer would have full use of the basket. If that same figure is less than 30 percent of policyholders surplus, then something less than the full basket would be available. The chart below illustrates how this concept would work for three companies:

	Company A	Company B	Company C
Policyholders obligations.....	\$200,000,000	\$1,000,000,000	\$500,000,000
Policyholders surplus.....	400,000,000	250,000,000	1,000,000,000
Basket, 30 percent of policyholders surplus.....	120,000,000	125,000,000	300,000,000
70 percent of policyholders obligations.....	140,000,000	700,000,000	350,000,000
100 percent of minimum capital and surplus (assuming maximum under sub. 4(a)(2)).....	7,500,000	7,500,000	7,500,000
Total.....	257,500,000	707,500,000	657,500,000

In the case of Company "C", unlike the other two, the "basket" of 30% policyholders surplus would not be available because the total of 70% policyholders obligations and 100% minimum capital and surplus is less than 30% policyholders surplus. In this case, the "basket" would become the difference between policyholders obligations and 70% policyholders obligations, or 150,000,000.

The language employed in S. 1710 is so vague we cannot safely assume the statute would work this way if enacted. It is possible to construe subsections 8(c) and 8(d) so that their restrictions apply to more than policyholders obligations plus minimum capital and surplus. If the restrictions do not apply to more than these categories, why is the basket written in terms of policyholders surplus?

5. The Federal Insurance Commission would be given power to review and approve certain proposed portfolio transactions, and to block entry into related businesses.

The Commission would be able to prescribe rules and regulations "in order to insure the financial stability of federally guaranteed insurers" (§ 107(a)). Such rules and regulations must require, among other things, that:

"Each insurer shall not sell, transfer, assign, pledge, or otherwise dispose of or relinquish control over more than 25 per centum of its funds, assets or investments within any twelve month period except as provided by regulation unless at least thirty days prior notice has been provided to the Commission and it has not disapproved."

This would be particularly troublesome in periods of high portfolio activity. During the first quarter of 1978, the SEC recorded the portfolio activity rate for property-casualty insurers was 37.8 percent. (Activity rate is the average of gross purchases and sales (annualized) divided by the average market value of holdings.)

The Commission would have broader powers over federally chartered companies. In addition to the provision quoted above, the federally chartered company must have Commission approval:

"[t]o conduct any other business which is complementary or incidental to the insurance business . . . subject to such limitations the Commission may prescribe for the protection of the interest of policyholders . . . after taking into account the effect of any such other business on the insurer's existing business and its surplus, the proposed allocation of the estimated cost of any such business and the risks inherent in any such business as well as the relative advantages to the insurer and its policyholders of conducting such business directly instead of through a subsidiary [§ 202(e)(8)]."

This would be bothersome to insurers which have expanded into financial services beyond insurance. A recent study by Stanford Research Institute predicts competition between financial institutions—insurers, banks, broker-dealers, investment advisors—will become more intense than in the past over efforts to provide one-stop financial services to high and middle income individuals.

6. The provisions in S. 1710 may leave the door open for development of a Federal annual statement for insurers.

The Commission would be empowered to make examinations of and to require information and reports from all federally guaranteed insurers, or applicants for a guaranty or charter (§ 101(a)(7)). Each federally guaranteed insurer would also be required to furnish financial reports or records at such times and in such detail as the Commission may prescribe (§ 107(a)). Every federally chartered insurer and every affiliated or controlling person shall comply with the Commission's rules and regulations, and shall make periodic reports in such form and detail as the Commission shall prescribe (§ 202(f)). Nowhere in S. 1710 are the issues addressed of the NAIC Annual Convention Statement's fate and whether statutory accounting principles would be followed by federally chartered insurers.

7. S. 1710 could materially alter the existing NAIC standards for valuing securities held by insurers.

The bill provides:

"(8) For the purposes of the limitations contained in this section (d), the property and securities enumerated in subsection (c) shall be valued at market value or at cost, less depreciation except that the Commission may, by regulation, authorize valuation of securities in accordance with stated values established for such securities in writing or as published by the Committee on Valuation of Securities of the National Association of Insurance Commissioners [205(d)(8)]."

This phraseology implies NAIC values will be used only as a last resort. Due to the language's vagueness, the Commission might be able to value stocks at cost,

and bonds at market. The disruption this could cause our companies needs no further emphasis.

Our members hope these comments on S. 1710 as a "working document to be studied and criticized" are responsive and helpful to your concerns. Please let me know if any further information might be useful.

Sincerely yours,

WALTER D. VINYARD, Jr., *Counsel*

FEDERAL INSURANCE ACT OF 1977

WEDNESDAY, SEPTEMBER 14, 1977

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:40 a.m. in room 5302, Dirksen Senate Office Building, Senator William Proxmire, chairman of the committee, presiding.

Present: Senators Proxmire, Brooke, and Tower.

Senator BROOKE [presiding]. The committee will come to order. Senator Proxmire, our chairman, is unavoidably detained, but will be in the hearing room as soon as possible.

Our first witness this morning will be Robert L. Dillard, Jr., executive vice president, general counsel, and secretary, Southland Life Insurance Co. of Dallas, Tex.

And with us today is our senior Republican member of this committee, my distinguished colleague, the Honorable John Tower, who will introduce Mr. Dillard.

Senator TOWER. Thank you, Mr. Chairman, I will be very brief.

I would only like to note that Bob Dillard is not only a leader in his professional field, but is highly regarded as a civic leader, a public spirited man in Dallas, and I think he will be a witness whose testimony we should give great weight to.

I welcome him here on behalf of the committee, and I will listen to what he has to say with interest. Thank you, Mr. Chairman.

Senator BROOKE. Thank you, Senator Tower. We are very pleased to have you, Mr. Dillard. After that sendoff, you may proceed. If you wish to summarize your statement, we do have questions we would like to ask you, and the full text of your statement will be printed in the record. But you may proceed.

STATEMENT OF ROBERT L. DILLARD, JR., EXECUTIVE VICE PRESIDENT, SOUTHLAND LIFE INSURANCE CO., DALLAS, TEX., ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURANCE AND THE HEALTH INSURANCE ASSOCIATION OF AMERICA

Mr. DILLARD. Fine. I will try to shorten it as I go. I am Robert L. Dillard, Jr., executive vice president, general counsel and secretary of the Southland Life Insurance Co., Dallas, Tex., and I am making this statement of S. 1710 on behalf of the American Council of Life Insurance and the Health Insurance Association of America.

These organizations have 582 members, and account for more than 92 percent of the life insurance in force in the United States and over 92 percent of the health insurance business written in the United States.

The council and the HIAA are committed to regulation of the insurance business which assures the greatest possible financial stability and the highest quality of protection for the public. Therefore, the associations devoted considerable attention to the concepts embodied in the Federal Insurance Act as first introduced by Senator Brooke in the 94th Congress.

When Senator Brooke introduced S. 1710 this year, both associations again carefully studied the concepts of the bill and the specific language it contained. The two associations have concluded that they must oppose the present bill for the following reasons.

First, we favor continued State regulation; second, the establishment of a Federal insurance guaranty fund—title I—is not necessary at the present time and the form outlined in S. 1710 needs considerable change; and third, the concept of optional Federal charters—title II—would do little to solve any existing problems and would complicate and weaken the current regulation of the insurance business.

Undoubtedly the concepts contained in S. 1710 are intriguing to some insurance companies. There are perhaps some companies which would agree with either or both of the concepts of optional Federal chartering and a Federal guarantee fund. Most, however, disagree with both concepts entirely.

Historically, the life and health insurance business has been regulated by the States through insurance departments varying in size from small to very large. The growth in size of the departments in the various States—currently estimated to be in excess of 5,200 employees, including examiners—has reflected the needs of the States and such factors as the number and size of companies domiciled in a State and the size of a State's population and its economy. Some of the insurance departments date back to the early 1850's and their history of expansion in number of employees and in statutory responsibility has largely paralleled our Nation's growth.

Within the 50 States and the District of Columbia, there are and will continue to be variations in the size, strength, and competence of the various insurance departments, but the system of State regulation has worked well and has been responsive to the recognized needs of the public.

The structure of uniform laws and regulations needed to accommodate the interstate nature of insurance company operations, particularly in technical areas, has been developed over a century. Although some areas of insurance operations need uniform regulation, State regulation also permits experimentation with different methods or approaches to regulation to be carried on in a single locality. This experimentation has often led to the development of regulatory ideas that proved successful and were later widely adopted. Other ideas were tested and discarded as failures. National regulation will not permit this type of experimentation, except with the risk of bad regulations carrying nationwide adverse consequences.

We do not imply that all issues of concern to insurance regulators, the public, or our own industry have been resolved.

There currently exist problems in regulatory areas that are the subject of intensive study. For example, frustrations in State regulation continue to arise because of variations in State laws that bear no apparent relationship to local conditions or problems differing in substance from other jurisdictions. There will no doubt be other problems that will arise in the future, primarily due to the rapidly changing nature and increasing complexity of our Nation's social and economic conditions.

However, these issues can be met through the existing basic State regulatory structure in a manner suited to serve well the public interest.

The proposals in S. 1710 could damage the intricately woven network of regulatory statutes, rules, and standards, and lead to the loss of its diversity, and its facility for innovation and experimentation.

We are of the opinion that while uniformity is desirable in many areas, it has to be uniformly good regulation in order for it to be desirable; bad regulation cannot become good regulation merely because it is uniform.

In addition, there might be less basic uniformity in some technical areas, where uniformity is necessary for interstate operations, if State and Federal regulations conflict.

The Council and the HIAA understand Senator Brooke's interest in the financial stability of the insurance business. We also understand the dangers that could arise if large companies were to fail in the future. However, we feel that the problems of the last several years in the property and casualty insurance business were met and solved under the present regulatory system, and that no drastic change in the present regulatory system is needed.

Since the problem of solvency was the main concern for Senator Brooke in drafting S. 1710, a few comments on the background of this subject might be appropriate at this time.

The subject of solvency in the insurance industry has received a great deal of attention in the last 10 years, including hearings before congressional committees on a number of bills introduced in the late 1960's. The cause for concern at that time arose out of the insolvencies in the late 1950's and early 1960's in the high risk automobile insurance industry.

I think it is well to point out here that there is a vast difference between the life and health insurance business and the casualty insurance business.

In response to these problems, the NAIC adopted a State Post Assessment Insurance Guaranty Association model bill in December 1969. Despite the absence of comparable solvency problems in the life and health insurance industry, the NAIC 1 year later adopted a State Life and Health Insurance Guaranty Association model bill. All but two States have enacted insolvency guaranty laws for property-liability insurance, and some 22 jurisdictions have life and health insurance guaranty laws, including some of the largest insurer-domiciled States, for example, Connecticut, New York, and Texas. There is one now

on the Governor's desk in the State of New Jersey, which would make 23 if he signs it.

This latter fact is of some importance in considering the degree of coverage nationwide since these laws, unlike the property-liability insurance laws, protect all policyholders and beneficiaries of the companies domiciled in those States.

Our associations supported the principle that insolvency guaranty laws should be at the State level, as opposed to a Federal act, and should be on a postassessment basis. We have consistently opposed the approach of a guaranty fund established on a prefunding basis as proposed in title I of S. 1710, whether at the State or Federal level.

I am going to briefly enumerate some of the specific objections we have to parts of S. 1710, in order hopefully to be helpful in connection with this committee's consideration of this proposed legislation.

For one thing, we feel that the authority given the Federal Insurance Commission by S. 1710 is excessive.

Compared to the more specific and certain regulatory language contained in most State insurance codes, the broad grant of rulemaking and regulatory authority under S. 1710 gives us great concern.

While effective regulation requires some degree of flexibility, the proposed grant of authority to the Federal Insurance Commission is stated so broadly as to allow the Commission to promulgate rules and regulations requiring potentially burdensome and unwarranted changes in the conduct of the insurance business.

There are a number of examples of this unlimited authority that is granted the Commission.

Some of them are provisions with reference to reserves under title I, capital and surplus under title II, and cash surrender values. All of these are all left to the regulation of the Commission, rather than being set by statute.

In the absence of a standard in the bill, a federally chartered company would not be certain that its liabilities would progress in a predictable fashion since reserve requirements could be changed abruptly by the Commission. The Commission could by regulation weaken or strengthen the reserves required for federally chartered life and health insurers. Such changes would result in sudden changes in earnings and surplus in companies' financial statements and could increase the income tax imposed by the Internal Revenue Code.

There are parts of S. 1710 we think are rather vague and ambiguous. For example, section 107(a)(5) mandates federally guaranteed insurers to prepare and furnish financial reports, but no accounting standards are prescribed. Thus, the Commission might adopt the same accounting basis used by the NAIC, the accounting basis developed by the American Institute of Certified Public Accountants for stock life insurance companies, or some unique method of its own devising.

Section 104(a) indicates that not all of an insurer's policies may be guaranteed. If this is the intent, it should be made clear which types of insurer obligations are not to be covered.

This has additional importance, since section 102(e) bases the annual guaranty fee on the level of premiums on policies guaranteed in accordance with the act.

Some of the other matters relate to the establishment of different levels of fees for different types of insurers. Section 102(e) speaks to

that. The language there creates serious concern as to how major separate lines of business would be treated in the event of an insolvency.

Again, I cannot overemphasize the fact that there is a very great difference between the life business and the casualty business.

The current State model guaranty bills developed by the NAIC make clear distinctions between life and health insurance on the one hand, and property liability insurance on the other. These distinctions reflect different objectives in the event of insolvency, which are due to the inherent differences in the types of coverage. If an insolvent property liability company is liquidated, its policyholders can readily obtain coverage from a new carrier; however, a life or health insurance policyholder may be unable to replace his coverage because of ill health or age. This consideration led the NAIC to draft a Model Life and Health Insurance Guaranty Act, which provides for continuation of coverage, and which includes health insurance as a covered line of business whether written by a life insurance company or a casualty company.

This division by major lines of coverage should be followed both in fees or assessments by the fund and in the payment of claims and other contractual obligations. Separation by lines of coverage not only recognizes differences in coverages, but also avoids subsidization by policyholders with one line of insurance of those with another. The need for such separation is emphasized by the provision in section 103(g), that would authorize all lines authority under a single charter. The necessary protection might be given by separate funds for separate lines of insurance, with appropriate provision for participation in more than one fund by multiline insurers.

There is no maximum limit on the fund's liability for claims against it. In contrast, the NAIC model bill, which sets forth a limit of \$300,000 on any one life, including \$100,000 in cash values. That latter limit is relatively generous in view of limits of coverage under FDIC and FSLIC.

We feel S. 1710 duplicates and conflicts with State regulation.

Federally chartered or insured companies will be subjected to regulations by both the State insurance departments and the Federal Insurance Commission, which always raises the specter of dual regulation, and this is despite the exemptions contained in the act.

There are a number of instances that you find duplication of regulation: capital and surplus, financial reports, financial examinations, holding company relationships, ancillary business activities, insolvency and liquidation laws, policy form approvals, and probably other areas, depending upon the interpretation that might be given this proposal by the Federal Insurance Commission.

In the past there has been considerable conflict between Federal and State regulators in areas of overlapping interest. It is only reasonable to expect more conflict if this proposal were to be enacted.

Increased expense is a natural result of duplicative regulation. How much of an increase is difficult to estimate. However, if the costs of operating the three Federal agencies which regulate the banking industry are any guide, there will be a considerable additional regulatory expense which will ultimately be borne by the public.

The proposal contains the seeds of conflicting regulations. A State-licensed insurer participating in the Federal guaranty program may conform to its State's investment requirements only so long as they are satisfactory to the Commission. Even though section 103(j) leaves insurer investments subject to State law, the Commission, under section 103(h)(B)(i) may reject the application if the companies' assets are not of "sufficient stability or integrity."

Another possibility for conflict is contained in section 203(a)(4) which grants the Commission the power to determine whether policies and contracts are in compliance with the Federal Insurance Act and with the applicable State laws. Thus, insurers could find that policy forms approved by all States in which they are to be used are disapproved by the Federal Commission.

We are of the opinion, also, as a practical matter, that the optional chartering concept may become mandatory for very practical reasons.

In actual practice it could become mandatory for smaller companies in particular to become federally insured or chartered.

For example, if the larger companies were to opt for the Federal guaranty, the effect would be a drastic reduction in the premium pool available for assessment under State agency associations.

I think this is a point a number of others have made in these hearings.

Smaller companies would run the risk of a crippling assessment from the insolvency of a medium-sized company under such circumstances. The only way such companies could eliminate this risk would be to join the Federal guaranty association. Once in the guaranty program, and subject to dual regulation of reserves, investments, reports, and examinations, an insurer would have no strong incentive to retain his State charter. This is particularly true if the insurer perceives some competitive advantage to obtaining a Federal charter.

Since companies applying for a Federal guaranty certificate must meet prescribed standards of financial soundness, all existing companies which cannot meet those standards would remain under existing State guaranty laws. This factor would provide an additional incentive to small and medium-sized companies to join the Federal program if they can qualify.

Additional pressure to join the Federal guaranty program will arise if participants in the Federal program were to be permitted to advertise that fact, as participants in the FDIC and FSLIC programs do, which is not permitted under the Model Act of NAIC. That would put insurers, who might otherwise wish to avoid duplicative or conflicting regulation, at a competitive disadvantage unless they join the Federal guaranty program.

There are other kinds of pressures that would be exerted by the bill which would lead companies to opt for Federal chartering and leave the weaker companies to the State regulation.

Section 204(a)(4) exempts federally chartered insurers from provisions of State law which "provide for the regulation or fixing of rates or premiums or of classes of risks." If the proposed Federal Insurance Commission were to interpret that language so as to include State statutes defining groups eligible for coverage by group contracts and State laws prohibiting agents from giving rebates to policyholders,

Federal insurers would have a distinct competitive advantage. This would lead most insurers to become federally chartered.

We are also concerned about the investment restrictions. Section 205 specifies the types of assets eligible for investment. It is intended to apply to the portfolios of all types of insurers, but does not fit existing portfolios for any single type of insurer.

On the other hand, State investment laws are very specific and detailed and permit different investments for various classes of insurers. The investment portfolios of our member companies have been built over many years in compliance with these laws and include assets that do not fit the restrictions of S. 1710. The amounts involved are quite substantial, and a life or health insurer having to change its portfolio to become eligible for a Federal charter might find it impossible to do so without suffering the losses attendant on forced sale.

Among investments commonly held by life insurers not included in section 205 are Canadian municipal and district bonds, obligations secured by liens on properties leased to high credit tenants and further secured by assignment of lease, leasehold mortgage loans, equipment trust obligations, and income-producing real estate.

The investment section of the current draft contains some vagueness. We find some other problems with S. 1710. One is that the proposal would extend the Federal bankruptcy laws to insurer insolvencies. It would make chapter X of the Bankruptcy Act applicable to rehabilitation or liquidation of a federally guaranteed insurer. Heretofore, insurers have been exempt from application of the Federal Bankruptcy Act, an exception which would continue under the bills presently pending before Congress.

That exemption has been retained because of the detailed State system of rehabilitation and liquidation laws. The possibly conflicting and overlapping or duplicative provisions could result in delays and confusion unless careful structuring of the provisions of applicable Federal law is accomplished.

We think a better approach would be to follow the State laws which give a liquidator or receiver broad and general powers, without imposing precise substantive and legal restrictions of chapter X of the Bankruptcy Act.

Another problem we find is that one section of the proposal applies the provisions of the Business Corporation Law of the District of Columbia to federally chartered insurers. This law needs very careful study before its acceptability can be determined. The enumeration of powers would not likely be suitable for a life or health insurance company, nor can provisions required for mutual companies be found. This section also raises the question of whether the District's Business Corporation Law, which is subject to future changes by the City Council, is appropriate for regulating corporations domiciled in other sections of the country and operating nationwide.

We are concerned that under section 101(d)(1), which establishes an advisory committee to "review the procedures, practices, and policies of the Commission" only 4 votes out of 13 can be spokesmen for the insurance business. The four insurance business representatives would include representatives not only of our members, but also of property and casualty insurers and of all lines of reinsurers.

In conclusion, the American Council of Life Insurance and the Health Insurance Association of America share many of the concerns that led Senator Brooke to develop S. 1710.

However, we must respectfully oppose its enactment, and we hope that consideration will be given to the reasons that led us to this conclusion.

[The complete statement of Mr. Dillard follows:]

STATEMENT OF ROBERT L. DILLARD, JR., EXECUTIVE VICE PRESIDENT, GENERAL COUNSEL & SECRETARY, SOUTHLAND LIFE INSURANCE COMPANY, DALLAS, TEXAS ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURANCE AND THE HEALTH INSURANCE ASSOCIATION OF AMERICA ON S.1710, ENTITLED THE "FEDERAL INSURANCE ACT OF 1977", BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

I am Robert L. Dillard, Jr., Executive Vice President, General Counsel and Secretary, of the Southland Life Insurance Company, Dallas, Texas, and I make the following statement on S.1710 on behalf of the American Council of Life Insurance (Council) and the Health Insurance Association of America (HIAA), whose 582 members account for more than 92 percent of the life insurance in force in the United States and over 92 percent of the health insurance written in the United States.

The Council and the HIAA are committed to regulation of the insurance business which assures the greatest possible financial stability and the highest quality of protection for the public. Therefore, the associations devoted considerable attention to the concepts embodied in the Federal Insurance Act as first introduced by Senator Brooke in the 94th Congress. When Senator Brooke introduced S.1710 this year, both associations again carefully studied the concepts of the bill and the specific language it contained. The two associations have concluded that they must oppose the present bill for the following reasons:

1. We favor continued state regulation;

2. The establishment of a federal insurance guaranty fund (Title I) is not necessary at the present time and the form outlined in S. 1710 needs considerable change; and
3. The concept of optional federal charters (Title II) would do little to solve any existing problems and would complicate and weaken the current regulation of the insurance business.

Undoubtedly the concepts contained in S. 1710 are intriguing to some insurance companies. There are perhaps some companies which would agree with either or both of the concepts of optional federal chartering and a federal guarantee fund. Most, however, disagree with both concepts entirely.

I. Existing State Regulation System

Historically, the life and health insurance business has been regulated by the states through insurance departments varying in size from small to very large. The growth in size of the departments in the various states (currently estimated to be in excess of 5,200 employees, including examiners) has reflected the needs of the states and such factors as the number and size of companies domiciled in a state and the size of a state's population and its economy. Some of the insurance departments date back to the early 1850's and their history of expansion in number of employees and in statutory responsibility has largely paralleled our nation's growth.

Within the fifty states and the District of Columbia, there are and will continue to be variations in the size, strength and competence of the various insurance departments, but the system of state regulation has worked well and has been responsive to the recognized needs of the public.

The structure of uniform laws and regulations needed to accommodate the interstate nature of insurance company operations, particularly in technical areas, has been developed over a century. Although some areas of insurance operations need uniform regulation, state regulation also permits experiment with different methods or approaches to regulation to be carried on in a single locality. This experimentation has often led to the development of regulatory ideas that proved successful and were later widely adopted. Other ideas were tested and discarded as failures. National regulation will not permit this type of experimentation, except with the risk of bad regulations carrying nationwide adverse consequences.

We do not imply that all issues of concern to insurance regulators, the public or our own industry have been resolved.

There currently exist problems in regulatory areas that are the subject of intensive study. For example, frustrations in state regulation continue to arise because of variations in state laws that bear no apparent relationship to local conditions or problems differing in substance from other jurisdictions. There will no doubt be other problems that will arise in the future, primarily due to the rapidly changing

nature and increasing complexity of our nation's social and economic conditions. However, these issues can be met through the existing basic state regulatory structure in a manner suited to serve well the public interest. The proposals in S.1710 could damage the intricately woven network of regulatory statutes, rules and standards and lead to the loss of its diversity, and its facility for innovation and experimentation. In addition, there might be less basic uniformity in some technical areas where uniformity is necessary for interstate operations, if state and federal regulations conflict.

The Council and the HIAA understand Senator Brooke's interest in the financial stability of the insurance business. We also understand the dangers that could arise if large companies were to fail in the future. However, we feel that the problems of the last several years in the property and casualty insurance business were met and solved under the present regulatory system and that no drastic change in the present regulatory system is needed.

Since the problem of solvency was the main concern for Senator Brooke in drafting S.1710, a few comments on the background of this subject would be appropriate at this time.

II. Company Solvency

The subject of solvency in the insurance industry has received a great deal of attention in the last ten years, including hearings before Congressional committees on a number of bills introduced in the late

1960's. The cause for concern at that time arose out of the insolvencies in the late 1950's and early 1960's in the high risk automobile insurance industry. In response to these problems the NAIC adopted a State Post Assessment Insurance Guaranty Association Model Bill in December 1969. Despite the absence of comparable solvency problems in the life and health insurance industry, the NAIC one year later adopted a State Life and Health Insurance Guaranty Association Model Bill. All but two states have enacted insolvency guaranty laws for property-liability insurance, and some 22 jurisdictions have life and health insurance guaranty laws, including some of the largest insurer-domiciled states (e.g., Connecticut, New York and Texas). This latter fact is of some importance in considering the degree of coverage nationwide since these laws, unlike the property-liability insurance laws, protect all policyholders and beneficiaries of the companies domiciled in those states.

Our associations supported the principle that insolvency guaranty laws should be at the state level, as opposed to a federal act, and should be based on a post-assessment basis. We have consistently opposed the approach of a guaranty fund established on a pre-funding basis as proposed in Title I of S.1710 whether at the state or federal level.

At this point, Mr. Chairman, we would like to offer some of our membership's broad objections to the concept and language of S.1710 with several examples taken from the bill:

III. Authority Given Federal Insurance Commission by S.1710 is Excessive

Compared to the more specific and certain regulatory language contained in most state insurance codes, the broad grant of rulemaking and regulatory authority under S.1710 gives us great concern.

While effective regulation requires some degree of flexibility, the proposed grant of authority to the Federal Insurance Commission is stated so broadly as to allow the Commission to promulgate rules and regulations requiring potentially burdensome and unwarranted changes in the conduct of the insurance business.

Sec. 202(e)(8) authorizes the Commission to prescribe unspecified limitations on the conduct of other businesses complementary or incidental to the insurance business in which a federally chartered insurer may be engaged. Sec. 202(f) further requires affiliates, parents (including holding company systems) and subsidiaries of federally chartered insurers to "comply with such rules and regulations as the Commission may prescribe." Such affiliates, parents and subsidiaries must also submit to examination or audit by the Commission and may be required to submit detailed periodic reports. Finally, Sec. 202(a)(4) would authorize the Commission to regulate the affairs of non-insurance companies having insurance affiliates.

Another example of the broad authority given the Commission is that reserves under Title I, capital and surplus of a Federally chartered insurer under Title II, and possibly cash surrender values, are left

to regulation of the Commission rather than being set by statute. In the absence of a standard in the bill, a Federally chartered company would not be certain that its liabilities would progress in a predictable fashion since reserve requirements could be changed abruptly by the Commission. The Commission could by regulation weaken or strengthen the reserves required for Federally chartered life and health insurers. Such changes would result in sudden changes in earnings and surplus in companies' financial statements and could increase the income tax imposed by the Internal Revenue Code.

IV. S.1710 is Vague and Ambiguous

Other parts of S.1710 are also vague and open to different interpretations. For example, Sec. 107(a)(5) mandates Federally guaranteed insurers to prepare and furnish financial reports, but no accounting standards are prescribed. Thus, the Commission might adopt the same accounting basis used by the NAIC, the accounting basis developed by the American Institute of Certified Public Accountants for stock life insurance companies, or some unique method of their own devising.

Sec. 104(a) indicates that not all of an insurer's policies may be guaranteed. If this is the intent, it should be made clear which types of insurer obligations are not to be covered.

This has additional importance since Sec. 102(e) bases the annual guaranty fee on the level of premiums on policies guaranteed in accordance

with the Act.

Further, the definition of "guaranteed obligation" in Sec. 2(6) leaves open the issue of who decides what the "coverage" is.

Sec. 2(9) would guarantee life and casualty insurance benefits. But as drafted, it may not guarantee annuity benefits, since the definition of "insurance" in Sec. 2(9) does not seem to be broad enough to include annuities. Similarly, there is no mention of variable life insurance in the bill. In the case of such life insurance policies, would the minimum death benefit, the variable death benefit, or nothing at all be guaranteed?

Sec. 102(a) provides that the Commission would establish different levels of fees for different types of insurers, "Provided, that all insurers of the same type shall pay comparable fees and the fees charged each type of company shall be reasonably related to expected losses." That language creates serious concern as to how major separate lines of business would be treated in the event of an insolvency. The current state Model Guaranty Bills developed by the NAIC make clear distinctions between life and health insurance on the one hand, and property-liability insurance on the other. These distinctions reflect different objectives in the event of insolvency, which are due to the inherent differences in the types of coverage. If an insolvent property-liability company is liquidated, its policyholders can readily obtain coverage from a new carrier; however, a life or health insurance policyholder may be unable to replace his coverage because

of ill health or age. This consideration led the NAIC to draft a Model Life and Health Insurance Guaranty Act which provides for continuation of coverage, and which includes health insurance as a covered line of business whether written by a life insurance company or a casualty company.

This division by major lines of coverage should be followed both in fees or assessments by the fund and in the payment of claims and other contractual obligations. Separation by lines of coverage not only recognizes differences in coverages but also avoids subsidization by policyholders with one line of insurance of those with another. The need for such separation is emphasized by the provision in Sec. 103(g), that would authorize all lines authority under a single charter. The necessary protection might be given by separate funds for separate lines of insurance, with appropriate provision for participation in more than one fund by multiline insurers.

Also, Sec. 102(e) provides that "any insurance obligations insured or maintained, exclusive of the reinsured obligation of a ceding insurer, by a federally guaranteed insurer during a period when such insurer is authorized to do business under this Act is guaranteed . . ." Thus, there is no maximum limit on the fund's liability for claims against it. In contrast, the NAIC Model Bill which sets forth a limit of \$300,000 on any one life, including \$100,000 in cash values. That latter limit is relatively generous in view of limits of coverage under FDIC and FSLIC.

V. S. 1710 Duplicates and Conflicts with State Regulation

Federally chartered or insured companies will be subjected to regulations by both the State insurance departments and the Federal Insurance Commission. Despite the exemptions contained in Sec. 204, federally chartered insurers will be subjected to duplicate regulation in the areas of licensing [Sec. 201(b)(3), 204(b)], capital and surplus [Sec. 202(a)(2), 203(a)(2)], financial reporting [Sec. 101(b)(7), 107(a)(4), 107(b)], financial examinations [Sec. 101(b)(7), 107(a)(4)], holding company relationships [Sec. 202(a)(3), (4)], ancillary business activities [Sec. 202(f)], insolvency and liquidation laws [Sec. 106, 107(b)], policy form approvals [Sec. 203(a)(4)] and quite possibly in other areas, depending upon the interpretation given to the law by the Federal Insurance Commission.

In the past, there has been considerable conflict between federal and state regulators in areas of overlapping interest. It is only reasonable to expect more conflict if this proposal were to be enacted.

Increased expense is a natural result of duplicative regulation. How much of an increase is difficult to estimate. However, if the costs of operating the three federal agencies which regulate the banking industry are any guide, there will be a considerable additional regulatory expense which will ultimately be borne by the public.

The proposal contains the seeds of conflicting regulations. A state licensed insurer participating in the Federal guaranty program

may conform to its state's investment requirements only so long as they are satisfactory to the Commission. Even though Sec. 103(j) leaves insurer investments subject to state law, the Commission under Sec. 103(h)(3)(i) may reject the application if the companies' assets are not of "sufficient stability or integrity."

Another possibility for conflict is contained in Sec. 203(a)(4) which grants the Commission the power to determine whether policies and contracts are in compliance with the Federal Insurance Act and with the applicable state laws. Thus, insurers could find that policy forms approved by all states in which they are to be used are disapproved by the Federal Commission.

VI. S. 1710's "Optional" Chartering Concept may become mandatory for practical reasons

The concept of a "regulatory alternative" is interesting. However, in actual practice it could become mandatory, for smaller companies in particular, to become federally insured or chartered. For example, if the larger companies were to opt for the federal guaranty, the effect would be a drastic reduction in the premium pool available for assessment under state guaranty associations. Smaller companies would run the risk of a crippling assessment from the insolvency of a medium sized company under such circumstances. The only way such companies could eliminate this risk would be to join the federal guaranty association. Once in the guaranty program, and subject to dual regulation of reserves, investments,

reports and examinations, an insurer would have no strong incentive to retain his state charter. This is particularly true, if the insurer perceives some competitive advantage to obtaining a federal charter. Since companies applying for a federal guaranty certificate must meet prescribed standards of financial soundness, all existing companies which cannot meet those standards would remain under existing state guaranty laws. This factor would provide an additional incentive to small and medium size companies to join the federal program if they can qualify.

Additional pressure to join the federal guaranty program will arise if participants in the federal program were to be permitted to advertise that fact, as participants in the FDIC and FSLIC programs do. That would put insurers, who might otherwise wish to avoid duplicative or conflicting regulation, at a competitive disadvantage unless they join the federal guaranty program.

Other sorts of pressure would be exerted by the bill. Sec. 204 (a)(4) exempts federally chartered insurers from provisions of state law which "provide for the regulation or fixing of rates or premiums or of classes of risks . . ." If the proposed Federal Insurance Commission were to interpret that language so as to include state statutes defining groups eligible for coverage by group contracts and state laws prohibiting agents from giving rebates to policyholders, federal insurers would have a distinct competitive advantage. This would lead most insurers to become federally chartered.

VII. Investment Restrictions

Sec. 205 specifies the types of assets eligible for investment. It is intended to apply to the portfolios of all types of insurers, but does not fit existing portfolios for any single type of insurer. On the other hand, state investment laws are very specific and detailed and permit different investments for various classes of insurers. The investment portfolios of our member companies have been built over many years in compliance with these laws and include assets that do not fit the restrictions of S.1710. The amounts involved are quite substantial, and a life or health insurer having to change its portfolio to become eligible for a Federal charter might find it impossible to do so without suffering the losses attendant on forced sale. Among investments commonly held by life insurers not included in Sec. 205 are Canadian municipal and district bonds; obligations secured by liens on properties leased to high credit tenants and further secured by assignment of lease; leasehold mortgage loans; equipment trust obligations; and income producing real estate.

The investment section of the current draft contains some vagueness. For example, Sec. 205(d)(4) limits investments in corporate obligations to 5 percent of the insurers "policyholder obligations" in "any one such investment." The limit should be in terms of investments in any one issuer; otherwise, it is meaningless, since multiple investments in the same issuer of 5 percent per investment, can lawfully result in holdings that the section is intended to prohibit.

Sec. 205(d)(8) says for the purposes of the limitations contained in Subsection (d) the "property and securities enumerated in Subsection (c) shall be valued at market value or at cost, less depreciation," but does not indicate whether there are any restrictions on the election of the valuation method.

VIII. Additional Specific Problems

Sec. 106(b) would extend Federal bankruptcy law to insurer insolvencies. It would make Chapter X of the Bankruptcy Act applicable to rehabilitation or liquidation of a Federally guaranteed insurer. Heretofore, insurers have been exempt from application of the Federal Bankruptcy Act, an exception which would continue under the bills presently pending before Congress. That exemption has been retained because of the detailed state system of rehabilitation and liquidation laws. The possibly conflicting and overlapping or duplicative provisions could result in delays and confusion unless careful structuring of the provisions of applicable federal law is accomplished. For example, while Sec. 106(b) gives priority to claims of policyholders, thus avoiding the "fair and equitable" (absolute priority) operation of a Chapter X proceeding, a question does arise with respect to priority of claims of beneficiaries, assignees and third-party claimants. A better approach would be to follow state laws which give a receiver broad and general powers without imposing the precise substantive and legal strictures of Chapter X.

Sec. 201(g) applies the provisions of the Business Corporation Law of the District of Columbia to Federally chartered insurers. This law needs very careful study before its acceptability can be determined. The enumeration of powers would not likely be suitable for a life or health insurance company, nor can provisions required for mutual companies be found. This section also raises the question of whether the District's Business Corporation Law, which is subject to future changes by the City Council, is appropriate for regulating corporations domiciled in other sections of the country and operating nationwide.

We are concerned that under Sec. 101(d)(1), which establishes an advisory Committee to "review the procedures, practices, and policies of the Commission," only four votes out of 13 can be spokesmen for the insurance business. The four insurance business representatives would include representatives not only of our members but also of property and casualty insurers and of all lines of reinsurers.

Conclusion

The American Council of Life Insurance and the Health Insurance Association of America share many of the concerns that led Senator Brooke to develop S.1710. However, we must respectfully oppose its enactment, and we hope that consideration will be given to the reasons that led us to this conclusion.

The CHAIRMAN [presiding]. Thank you very much, Mr. Dillard, for a strong incisive and clear statement. At least we know where you stand.

The question that occurs to me first is you say that you represent the life and health insurers in the country, your organization has 92 percent, as I understand it, of the life insurance in force and the health insurance in force.

What action did you take to ascertain the opinion of your constituent members? Was there a convention, was there a poll of any kind, was there any kind of determination that documents your assertion that the industry opposes this?

Mr. DILLARD. Senator, we have an elaborate committee structure that handles such matters. Our legislative committee deals principally with matters of this kind. And where it is a specialized kind of legislation, as this is, the legislative committee of the council sets up a task force.

It happened that I chaired this task force, and on the task force were the representatives of the largest of the life companies, and some of the small life companies, as well as several from the health industry, a very representative task force of about 18.

With a lot of preliminary work by the staff, we spent a day reviewing the legislation and coming to the adoption of a resolution.

This resolution then was presented to our Legislative Committee, which again is a very large representative committee.

The CHAIRMAN. How large is that committee?

Mr. DILLARD. It has 17 members. The HIAA is Government Relations Committee, which has 20 members, used the same process, although the task forces met together.

Then after that was done, our Board of Directors, which has 30 representatives elected by the membership, spent a day reviewing it, as I understand, at their meeting in the first part of September, and the whole process resulted in the position we have taken here today.

The CHAIRMAN. Was there dissent? Was this a consensus view, or a unanimous view?

Mr. DILLARD. I believe that we did not have a single dissent in the task force or the Legislative Committee. The Board approved the motion unanimously.

The CHAIRMAN. One of the problems that troubles me about this situation—Senator Brooke has indicated that he is concerned about the underwriting losses suffered by property-casualty insurance companies and the ability of the State guaranty funds to handle potential insolvencies of this type.

Of course, we have to be concerned about the losses in your area, too. I wonder if you could indicate the position you are put in if we have a serious inflation? As I understand it, the life and health people, particularly the life people, would be more vulnerable, perhaps, to a serious inflation than to almost any other kind of development, including a depression.

I wonder if thought has been given to the adequacy of the State funds to weather that kind of say double-digit inflation for a number of years?

Mr. DILLARD. Senator, I think really inflation impacts us differently and much less than it does the property and casualty business, because

it is obvious that as you go along, for example, in the automobile business, the cost of repairing fenders and putting new parts on automobiles has been tending to go up very drastically.

Particularly in the life business, your dollars are fixed dollars, a \$1,000 policy now is \$1,000 when the man is dead, and there is no difficulty usually about determining that.

Now there is some impact, obviously, on the health side, particularly in the group health. But most of us have gone to the proposition of holding our rate guarantees to less than a year's time.

I know in my own company, we don't guarantee the group rates for more than 6 months, except for a very substantial added premium. Then, too, these are on an annual basis, so the companies are able to adjust rates so as to take care of the rising health costs.

I will say we have been very concerned about rising health costs. But we think we are in a much better position to handle the inflationary spiral than the property and casualty business.

The CHAIRMAN. That puzzles me somewhat because my conversations with life insurance people in my State have indicated their deep concern with inflation, and what they say would be a devastating effect of continued high inflation.

They point to the fact that their investment income and premium income is fixed for long periods, and adjusting is difficult.

Let me ask you this: You oppose the bill, and yet you say only 22 States, as I understand it, have adopted their own life and health insurance guaranty laws.

Can you give us an estimate of what percent of policyholders are left unprotected by any State guaranty law covering these lines of insurance?

Mr. DILLARD. I am sorry, I cannot give you that estimate. I will say this, as far as the number of State laws are concerned, our problems of solvency in the life business have been really very, very minor. I happen to be chairman of the Texas Guaranty Association, and our problems there just have been minuscule. They are just so small they are hardly consequential. We ran one very small assessment, and haven't even paid out all of the money on that assessment as a matter of fact.

The CHAIRMAN. Let me see if I understand the significance of this. If 22 States, only 22 States have adopted their own life and health insurance guaranty laws, does that mean in the other 28 States, the majority of the States, that there is no State protection, no legal protection in the event of default by an insurance company, life insurance company, or health insurance company?

Mr. DILLARD. No. You see, contrary to the property and casualty Guaranty Association bills, the life bills provide protection for policyholders wherever situated.

This means that for a company domiciled in a State with a life insurer guaranty plan, the protection in the event of an insolvency extends to all of the company's policyholders, even those residing in States without life guaranty plans. This is important in view of the fact that there are some States that have very few or perhaps no domiciled life insurance companies.

Further, as I stated earlier, such guaranty plans are in effect in some of the most populous States, which, incidentally, are also the States in which a majority of life insurers are domiciled.

Most of our life companies do business widely in the United States. Therefore, the protection afforded by these existing life guaranty plans is much broader and much more comprehensive than it would be if, as with the property/casualty plans, such protection were just confined to the residents of a particular enacting State.

So the truth of the matter is the protection is much broader and much more comprehensive in the life side, because if a company is doing business in a particular State that doesn't have a guaranty bill, guaranty association law, they still, if they are insolvent, they still have to protect all of the policyholders in that State under the law.

So that the coverage, you see, is much broader than it would be if it were just confined to the residents of a particular State. Because most of our life companies do business widely in the United States.

The CHAIRMAN. My time is up. I just have one other question.

You say that the proposals in S. 1710 could:

Damage the intricately woven network of State insurance regulation, lead to the loss of its diversity, and facility for innovation and experimentation.

But the intent of the Brooke bill is to create a dual insurance system similar to the dual banking system, and to use the Federal alternative to inspire better regulation at the State level.

There is no evidence that the dual banking system has stifled State innovation. To the contrary, many of the most innovative developments in banking recently, such as the NOW accounts, have been developed at the State level, in spite of the fact we have a very comprehensive Federal regulation.

What evidence do you have to suggest that Federal involvement would damage and not improve the quality of State insurance regulation?

Mr. DILLARD. Well, I suppose that is really a subjective judgment. But it seems to me that there is such a vast difference between regulating banks that operate in one State and in many places operate only in one location—as in our State, we do not permit branch banking—that the opportunity for development of regulatory ideas, when spread across 50 jurisdictions, is much greater than when concentrated in one Federal agency.

As I say, I cannot come forward with any facts or figures, and I guess it is subjective judgment.

The CHAIRMAN. Well, of course the idea behind S. 1710 is not to concentrate regulation at the Federal level at all. The idea is that the State regulation would continue, and you would have a dual system, and you would simply have an additional option for insurance companies, if they volunteered to do so, to joining the Federal system. There is nothing mandated, and it is with the understanding that the 50 States would continue their regulation.

Mr. DILLARD. This, of course, poses other problems, too, where there is duplication and no elimination of the duplication of regulation. Particularly in such matters as policy approval, and that sort of thing.

The CHAIRMAN. Senator Brooke.

Senator BROOKE. Thank you, Mr. Chairman.

Mr. Dillard, you state that perhaps some of your companies would agree with either or both concepts of optional Federal chartering and the Federal guaranty fund, but that most of them disagree with both concepts entirely.

I suspect from the comments I have heard that there are a number within your association who would support this legislation or some modified form of it.

When you state that most of your member companies disagree with the proposals entirely, I am not surprised, since I know that your membership includes many smaller companies, with regional biases, who are against any change, really, in the status quo.

And I am well aware that the opinion of the insurance commissioners who oppose this legislation carries considerable influence in your industry. I think that was made crystal clear to us in the testimony which we received more particularly yesterday.

But I would like to ask you these questions: How many States have adopted life and health guaranty plans? Twenty-two, did you say?

Mr. DILLARD. Twenty-two, yes.

Senator BROOKE. In most States, both property liability and life and health guaranty funds have been proposed in approximately the same time frame. To date, our information indicates that only 17 States have adopted life and health guaranty laws, whereas 48 States have property liability guaranty funds.

Why has adoption of life and health guaranty funds lagged so far behind adoption of property liability laws?

Mr. DILLARD. I think that there has been some resistance in the life business to the adoption of these guaranty bills. And simply on the proposition that there wasn't really a problem in this field, as there was in the property and casualty field.

We know that really the pressure has been in the property and casualty field, and not in the life field, because losses in the life field have been very, very small, and the commissioners themselves have been able, in most instances, to overcome the problem, where they have had problems in the life field.

So there has been some resistance. And I agree that the pressure has not been the same at all.

Senator BROOKE. Do you know whether life insurance companies opposed the adoption of life and health guaranty plans in some States?

Mr. DILLARD. I think they have in some States where there was no premium tax offset, that sort of thing. The ACLI's position has been they favored them if they had a tax offset.

Senator BROOKE. I referred yesterday to an article by Jack H. Blaine, appearing in the spring 1977 edition of *Forum*, which said, "State guaranty plans seem to be plagued by constitutional and other legal problems."

Do these serious and continuing legal difficulties comprise the effectiveness in your opinion of the State guarantee funds?

Mr. DILLARD. Not really. I kind of dreaded that question, Senator. I told Jack Blaine I wasn't going to defend him in any way. But I

don't think it has been a real inhibition against the adoption of these laws.

As you know, the first one that went to the Supreme Court of Washington, they sustained it, the constitutionality of it. Obviously when you take a new concept like this and lay it out before companies and lawyers, you have some resistance to the idea.

But basically I don't think there is but one State that has knocked it out, and that was on purely technical grounds, and they have re-passed it to meet those technical objections, so I don't think that has been a real serious problem.

Senator BROOKE. Now Mr. Robert Hunter, of the Federal Insurance Administration, in his statement on Monday, testified:

We have yet to be convinced that form approval, which the bill clearly leaves to the States, is so divorced from financial or rating concerns that divided responsibility is either feasible or desirable.

Now we have heard many complaints from companies about the increasing number of different insurance policy forms prescribed by the States and the burden this places on companies doing business in many different States. You say in your judgment "Frustrations in State regulations continue to arise because of variations in State laws that bear no apparent relationship to local conditions or problems."

If the Federal Government were to offer alternative regulation for solvency purposes, do you think that such regulation would be more attractive to your members if it provided for Federal rather than State regulation of policy forms?

Mr. DILLARD. I think that is a step in the right direction, I would have to say that, yes, sir. What is said there in my statement, and by Mr. Hunter, is true. There are frustrations, there are difficulties involved in multi State approval of policy forms and that sort of thing.

Certainly that is a real problem for our business, I have to say that, you are right.

Senator BROOKE. Now in my opening remarks I mentioned the Washington Post article entitled "How an Insolvent Firm Keeps Selling Insurance." I have asked the staff of your association to bring that article to your attention. I presume that they did?

Mr. DILLARD. I have seen it before, yes, sir.

Senator BROOKE. I am submitting a copy of the article for inclusion in the record at this point.

Mr. Chairman, I would like to include a copy of that article in the record.

The CHAIRMAN. Without objection, that will be printed.

[The article follows:]

[From the Washington Post, May 26, 1977]

HOW AN INSOLVENT FIRM KEEPS SELLING INSURANCE

(By John F. Berry)

COLUMBIA, S.C., May 24.—Eight years ago Mr. and Mrs. Odell A. Mize made the final payment on a \$500 life insurance policy they had taken out 10 years earlier on their son.

The Mises' policy provided in writing that the company, New South Life Insurance Co., based here in Columbia, would pay on demand the value of the policy in cash or make a loan against that value.

But recently, when the Mises tried to get money from the company for a down payment on a mobile home for their son's wedding present, they learned that New South was not honoring its commitment.

"We tried two or three times to cash the policy in," Mrs. Mize said. "I guess there's not much we can do."

The reason that the Mises and about 175,000 other policyholders cannot get their money without dying is that New South has been insolvent since 1971 and the policyholders' money is being used—interest free—to bail out the company and its owners.

What is more, New South salesmen are still peddling policies to unsuspecting buyers who apparently are not aware of the company's financial difficulties.

The complex and questionable scheme to bail out New South has been directed by former South Carolina Gov. Robert McNair, the company's counsel. The policyholders' funds are being used to rescue a personal friend and political ally, Lester L. Bates, Sr., chairman and majority stockholder of New South and former mayor of this city.

Most of the New South policyholders do not seem to know what is happening. New South sells a form of coverage known as debit life insurance. The policies are higher-priced than comparable coverage, because salesmen come to the policyholders weekly or monthly to collect premiums. About 90 per cent of New South's policyholders are poor blacks living in rural areas of the state.

Few have contacted the state insurance department since it belatedly—in 1972—made public New South's collapse.

NO FEDERAL STANDARDS

There are no federal standards to protect policyholders, and there are no signs that Congress is willing to tackle the problem.

At present, for all practical purposes, small insurance companies that deal only in one state are regulated by that state's insurance department. And many of these departments (there are a few notable exceptions), instead of protecting buyers of insurance, have become extensions of business and political interests.

Federal Magistrate Charles W. Gambrell, one of the former South Carolina insurance commissioners interviewed for this story, blamed the system for the New South affair.

"This whole debacle is the accumulation of 50 years of indifference to insurance regulation," he said. "I'm humiliated that New South's troubles could have been overlooked so long."

In preparing this article, The Washington Post reviewed the sizable accumulation of court documents related to the case and interviewed many of the principals and sources familiar with it. Some refused to talk in detail because of legal implications; others requested anonymity because they feared retribution from powerful state figures involved.

THE ESTABLISHMENT

What emerged, however, is the story of how prominent members of South Carolina's business and political establishment joined forces to stave off personal financial and legal liabilities of New South's principal owners.

The 71-year-old Bates founded Capital Life Insurance Co. in 1936. Capital, like his present firm, sold debit life insurance.

Capital seemed to be thriving in the 1930s. But by the late 1940s the company was found by the state insurance department to be short of necessary reserves to pay policyholder claims. (This same problem would crop up two decades later with New South.)

Whether the reserve deficiency was real or imagined, Bates was forced to sell his company to a Chicago outfit called United Life Insurance Co.

To this day, Bates claims he lost nearly \$1 million in the forced sale.

In 1955, Bates got back into the debit life insurance business when he founded New South to sell policies within South Carolina.

Bates was active in business and politics and was elected mayor of Columbia in 1958. He ran unopposed two more times before retiring in 1970 on the eve of the New South debacle. He also ran unsuccessfully for governor in 1946 and 1950.

SERIOUS PROBLEMS

By then, New South had about 180,000 policyholders and an annual income from premiums of more than \$6 million. On paper, the company looked prosperous,

and examiners from the insurance department, who went over the company's books every three years, never saw any problems.

But, in fact, there were serious problems at New South. It is a measure of the quality of the state insurance examination system that it failed to discover that, each year, New South was sinking deeper and deeper in red ink. The reason: New South's books and computer printouts were being deliberately altered to make the company look more profitable than it really was.

The man who would later be accused of rigging the records was Louis J. Glaser, a bookkeeper Bates had hired away from United Life. One of the unanswered question in the whole affair is why, after accusing United Life of cheating him out of nearly \$1 million in the sale of Capital Life, Bates hired the man who had calculated the worth of his company for United.

In 1969 Glaser was accused of stealing money from the company by forging loans on insureds' policies. He got the checks, which were cashed by a friendly cashier.

CHARGES NOT PRESSED

But Bates did not press charges. Bates' son, Lester L. Bates Jr., who is president of New South, said in an interview that the reason was that Glaser had just had open-heart surgery.

Glaser retired to Clearwater, Fla., where he made a settlement, reportedly in five figures, on unpaid taxes with the Internal Revenue Service.

As it turned out, the revelation of Glaser's admitted caper was small change compared with what was to come.

In the spring of 1971, New South's consulting actuaries made a troubling discovery. They discovered that New South did not have enough financial reserves to meet future policyholder claims.

Reserves are the amounts actuaries calculate that a life insurance company will need to pay policyholders. The ratio of reserves to insurance outstanding is set by state law.

James L. Athearn, an insurance professor at the University of South Carolina College of Business Administration, describes reserves this way: "The reason for establishing reserves is to force a company to recognize it must accumulate assets to pay claims. The function of reserves is to keep a company from frittering away its assets."

It is clear that, when New South was warned by the outside actuaries of the reserve deficiency, the state insurance department should have been notified so it could conduct an audit. But Bates told neither the department nor the company's stockholders.

AN OPTIMISTIC REPORT

Indeed, the younger Bates sent an optimistic quarterly letter to shareholders, dated Aug. 9, 1971, several months after the discovery. He told them that the company was following "an extremely good trend."

During a recent interview with a reporter, Lester L. Bates Jr.'s attorney advised him not to discuss the August letter because of possible litigation.

It was not until the fall of 1971 that New South informed the insurance department that it had problems, some six months after they were turned up by the actuaries. And it was not until February, 1972, that the insurance department told the public of the New South situation.

By South Carolina law, an insurance company is required to report any "impairment" to the insurance commission immediately—a fact that Bates should have known, since he was a member of the insurance commission at the time.

Bates in his defense says that he was not aware of the extent of his company's difficulties immediately.

By then, moreover, the groundwork had been laid for the bailout of New South's board members, officers, and stockholders at the expense of its policyholders.

When the truth finally surfaced, it turned out that New South was awash in red ink with liabilities exceeding assets by more than \$9 million. The company was legally insolvent, with assets of \$14.1 million against liabilities of \$23.1 million.

Glaser and the two Bates were indicted by a county court here on criminal charges of conspiracy and filing false financial statements. Glaser was never served with a warrant because of his poor health, and he died a short time later of a heart attack. In February, 1972, the Bates were found not guilty of the complicated charges growing out of the staggering \$9 million deficit at New South.

A NEW PLAN

The Bates, who had been on leave from New South during the trial, returned to the company. That same month a rehabilitation plan was submitted to state Circuit Court Judge John Grimbball, who, in June, accepted the unorthodox scheme.

Under the rehabilitation plan:

A lien was put on the company's reserves so that policyholders could not get the cash value provided for in their policy contracts. In short, an insured person had to die to get money that should be rightfully his alive.

Thirteen million dollars of the reserves were put on the asset side of the company's ledger. By the stroke of his pen, the judge erased the \$9 million deficit and created a \$4 million surplus, allowing the company to continue selling policies.

Stockholders and policyholders were enjoined from suing the management or the board of directors.

Describing the rehabilitation plan in the *Business and Economic Review* published by the University of South Carolina, Professor Athearn wrote, "In effect, policyholders have made an involuntary loan to the company at a zero rate of interest . . . There is no guarantee when this loan will be paid back, or, in fact, if it will be paid."

Actually, the rehabilitation plan was created by New South's attorneys, former Gov. McNair, whom the company hired, when it learned of its problems, and C. Heyward Belser, another politically connected lawyer.

NO COURT CHALLENGE

South Carolina law stipulates that when a company is insolvent the insurance commission "shall" stop it from doing business. But Chief Insurance Commissioner John W. Lindsay never went to court to challenge the judge, who effectively usurped the commission's authority when he prohibited the commission from "holding any further hearings or revoking or suspending the license" of New South.

The same management that presided over the company's insolvency was left in place, immunized from suit by judicial decree. The elder Bates was quoted in September, 1972, as saying that he knew "not one thing in this world about insurance reserves. My education is limited to about a fifth-grade education."

The principal players in the New South bailout are members of the South Carolina establishment.

For example, McNair and Bates are old political allies, as is the chairman of the insurance department, Claude McCain, who was in the state senate with McNair and was the ex-governor's roommate in college.

Belser, the outside attorney for New South who presented Judge Grimbball with the rehabilitation plan, is related by marriage to the judge.

Bates was a member of the five-member insurance commission until December, 1971, well after his company became insolvent.

ON THE BOARD

The New South board—which had been shielded from suit by the judge's order—includes William F. Austin, a former insurance commissioner and a prominent attorney, Edward K. Pritchard, another well-known attorney here, Marshall A. Shearouse, an officer of a leading bank, C. Wallace Martin, a vice president of the University of South Carolina, and David McLeod, a brother of the state attorney general.

Soon after New South's insolvency was revealed, the legislature moved to create the South Carolina Life and Health Insurance Guarantee Association. Each company must join, and if one fails the others are assessed pro-rata to pay off policyholder claims.

The trouble is that although the failure of New South caused the association to be formed, its policyholders—even its new policyholders—are not covered. The reason: the state supreme court declared in 1976 that the \$13 million lien asset created by Judge Grimbball was not an asset at all.

Said the court: "The cash value of the life insurance policy is a debt owed to the policyholder and it cannot be transformed into an asset of the company by court decree."

What this means is that New South is right back where it was in 1971, before Grimbball's decree. But the high court's decision has not affected Grimbball's refinancing decree nor has it stopped New South from busily writing new policies.

MORE NEW POLICIES

Indeed, new policies must be written so the premiums can be used to keep the company afloat and to pay off the death claims of old policyholders. Moreover, premium rates have been boosted as much as 166 per cent to provide more income for the company.

In an interview, Judge Grimball refused to answer when asked if he would buy his life insurance from New South.

Ex-Gov. McNair, for his part, said that he would have no problem buying life insurance today from New South because "I think policyholders are fully protected."

Not everyone here in Columbia has gone along with the scheme, but most critics shy from going on the record.

Howard Clark, who was chief insurance commissioner when the state supreme court said the lien was not an asset, tried to yank New South's license. Judge Grimball, however, blocked him with an unwritten order.

Both Price Waterhouse Co., the major accounting firm, and the American Academy of Actuaries have refused to join Judge Grimball in recognizing the lien as an asset, thus confirming that New South is, in fact, insolvent.

And Joseph Nobeck, an actuary who was an expert witness in hearings against the bail-out scheme, said in a recent interview: "On the New South application form for new policies there should be printed in bold face—perhaps red ink—'You are buying this policy from an insolvent company.'"

Senator BROOKE. Is the New South Life Insurance Co. a member of your association?

Mr. DILLARD. No sir.

Senator BROOKE. Has your association had occasion to look into the facts of the New South case?

Mr. DILLARD. Well, I think most of us are familiar with the facts surrounding it, and probably many of us have been offered the opportunity to help bail it out. I know I was offered that opportunity on behalf of my company, to bail it out.

Senator BROOKE. You didn't accept the offer?

Mr. DILLARD. I didn't accept the offer, no, sir.

Senator BROOKE. As I understand it, South Carolina has a life and health guaranty plan, but it doesn't appear to be of much help to the policyholders of New South, who cannot borrow against their policies or obtain their cash surrender value as they were promised in their contracts. Don't you agree?

Mr. DILLARD. Yes. The reason for that, of course, though, is the New South was insolvent before the South Carolina legislature passed the law, and made the guaranty law effective. Otherwise it would have applied.

Senator BROOKE. But the policyholders are injured though?

Mr. DILLARD. Yes. As I understand it, based on a very complex situation, they have put a policy lien against the cash values, the loan values of all of the policies, yes, sir.

Senator BROOKE. Has New South actually been declared insolvent?

Mr. DILLARD. Well, the trial court arrived at a rather peculiar result in that case, and sort of boot-strapped the operation by setting up the loans on those policy reserves as an asset, at least technically restoring it to solvency by that action, which is a rather peculiar way to do it.

Senator BROOKE. What would you say the status of it is?

Mr. DILLARD. It is my understanding, and I will have to say this is hearsay, or what I read in the papers, my understanding is that they are continuing to write business, and continuing to collect premiums off all of the business.

Senator BROOKE. So you presume they are solvent?

Mr. DILLARD. I don't think they are, but then that is what the result has been in South Carolina, I understand. I don't say they are solvent, no, sir.

Senator BROOKE. If you were the regulator in South Carolina, would you handle it that way?

Mr. DILLARD. No, sir.

Senator BROOKE. Well, that very well may be an example of the weakness of State regulation, isn't that right?

Mr. DILLARD. Well, that could be, yes, although my reading of that, what I know of that case, indicates to me that there is not only a matter of some weakness in regulation, but principally a matter of fraud and dishonesty, because of the manner in which the records were altered in the case.

Senator BROOKE. I don't even know that I should mention this, and it certainly has nothing to do with my reasons for developing this legislation, but there have been a number of indictments and convictions of the insurance commissioners around the country, unfortunately. It is a bad run on the insurance commissioners. I hope that won't continue, because obviously, if that continues the public's confidence in insurance regulation will be eroded.

That also is a matter of grave concern so far as the regulation of insurance companies. This is something that I am sure you are very much concerned with yourself, Mr. Dillard. I know of your very distinguished record and service.

Mr. DILLARD. Senator, I think that when you have dishonest people, you have them in the Federal Government just like you have them in the State government, and it would be just as easy to have a dishonest Federal administrator of insurance as it would a State one.

Senator BROOKE. I haven't heard of too many Federal insurance regulators or banking regulators, thank God, who have been indicted. I don't remember any, do you? Not that we have any monopoly on virtue.

But, as I have said, this will require even closer scrutiny of some of the activities of State regulators.

Mr. DILLARD. It has to be a concern, of course.

Senator BROOKE. As I say, we had a spate of indictments and convictions.

You mention your concern about the fact that S. 1710 provides for only one guaranty fund, but you recognize that the Federal Insurance Commission would be expected to establish different fees for life and health and for property and casualty companies, reflecting the difference in the type of exposure each type of company has.

I don't quite understand that concern. Could you expand upon that?

Mr. DILLARD. Well, of course, our feeling is that any problem in the life field particularly is a problem that is de minimus as far as the amount of money is concerned, as compared with the property and casualty field.

In the case of these guaranty funds, State guaranty funds, there is a division between the life side and the health side, for example, because the health side has the aspects of casualty insurance. So we felt that any structure that was set up on the guaranty side should clearly

differentiate between the life and the casualty sides, or the various lines of business, because of the very difference in the amount of risk.

Now the life insurance business has a great ability to resurrect itself. It can build itself back up, even when it has been stolen from or impaired, and this is not true in property and casualty insurance. The life business has that faculty, because of the type of business it is. That is the reason we think that the matter of any guaranty funds ought to take those facts into consideration in fixing a rate for the coverage.

Senator BROOKE. Now are annuities covered under the present State life and health guaranty plans?

Mr. DILLARD. Yes, annuities are covered under present life and health guaranty plans in all of the States which have enacted such plans.

Senator BROOKE. Now you raise questions about investment provisions in S. 1710, and I have stated many times that I am open to any suggestions for changes.

Could you also amplify your concern and supply for the record any alternate set of investment criteria that you feel would be desirable?

Mr. DILLARD. Yes, we could amplify that; yes, sir. I think maybe there was one remark in our legislative committee that was typical, when he said,

I don't believe there is a company represented around this table that can make its portfolio comply with the restrictions in S. 1710.

As you know, Senator, the State laws are very comprehensive in their scope. They are not broad in the sense that they leave it to the companies' discretion, but they are very specific, and they do cover a great scope of types of investments. And they have been developed over many years in most States through a process of legislative action, so as to protect the solvency of the companies, but at the same time permit the companies to make the proper kinds of investments without artificial restrictions on the type of investments they make.

Senator BROOKE. I would be very grateful for any alternate investment criteria you might wish to recommend.

Mr. DILLARD. We would be glad to do that, sir.

Senator BROOKE. Thank you very much, Mr. Dillard. You have been very helpful. We are certainly grateful to you.

The CHAIRMAN. Thank you, Mr. Dillard, for a very powerful and effective statement. We appreciate your testimony.

Now I am going to ask the next witnesses to come forward together as a panel, and I will call out their names.

Mr. Marvin L. Pearce, president, Professional Insurance Agents; Mr. Edward J. Kremer, chairman, Federal affairs committee, Independent Insurance Agents of America; Mr. H. James Douds, general counsel, the National Association of Life Underwriters; Mr. Jean C. Hiestand, vice president, counsel, State Farm Insurance Cos.; and Dr. Dennis Reinmuth, director of special projects, League Insurance Group.

We would like to have it arranged so each of the main witnesses will be sitting at the table with access to the microphone, and those who are accompanying them sit perhaps behind. What is your name, sir?

Mr. REINMUTH. Reinmuth.

The CHAIRMAN. Perhaps you should move over to a microphone.

Gentlemen, I am going to ask the clerk to turn the time-light on here, because we would appreciate it if you make each statement about 10 minutes. You don't have to feel your throat is cut when the red light goes on, but we would appreciate it if you would terminate as soon as that happens. When the green light is on, it means you are all set. When it turns yellow, you have 1 minute left. The green is on 9 minutes, the yellow on 1 minute, and red means we hope you will be able to conclude as soon as possible.

Our first witness is Mr. Marvin L. Pearce, of the Professional Insurance Agents.

Mr. Pearce.

STATEMENT OF MARVIN L. PEARCE, PRESIDENT, PROFESSIONAL INSURANCE AGENTS, ACCOMPANIED BY EDWARD O'ROURKE, STATE LEGISLATION AND REGULATION COMMITTEE, PIA

Mr. PEARCE. Mr. Chairman, my name is Marvin L. Pearce, of Fremont, Ohio. I have owned and operated an insurance agency in partnership with my brother since 1946. I am also president of the Professional Insurance Agents, formerly the National Association of Mutual Insurance Agents. PIA is a national association of 30,000 property and casualty insurance agents from all 50 States, Puerto Rico, and the Virgin Islands, with headquarters in Washington, D.C.

With me today is Edward H. O'Rourke, an agent from Louisville, Ky., and a member of PIA's State legislation and regulation committee. He is also a member of the board of directors of the Kentucky Insurance Guaranty Association and is appearing with me today because of his firsthand knowledge of the regulation of insurers for solvency in his State.

Mr. Chairman, I would like to summarize as briefly as possible my prepared statement, but I would respectfully request my entire statement be put in the record.

The CHAIRMAN. All statements will be printed in full in the record.

Mr. PEARCE. In addition, Mr. O'Rourke has brought a memorandum to Senator Proxmire and the committee from Insurance Commissioner Harold B. McDuffy, Commonwealth of Kentucky, president-elect of the National Association of Insurance Commissioners, and we would like to have this entered into the record also.

The CHAIRMAN. Without objection, it will be printed in the record.

[Mr. Pearce's prepared statement and the memorandum referred to follow:]

STATEMENT BY
MARVIN L. PEARCE, CPCU, CIC, CLU, PRESIDENT
OF THE
PROFESSIONAL INSURANCE AGENTS
ON S. 1710
THE FEDERAL INSURANCE ACT OF 1977

SUBMITTED TO
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

SEPTEMBER 14, 1977

Mr. Chairman, my name is Marvin L. Pearce of Fremont, Ohio. I have owned and operated an insurance agency in partnership with my brother since 1946. I am also President of the Professional Insurance Agents (PIA), formerly the National Association of Mutual Insurance Agents (NAMIA). PIA is a national association of 30,000 property and casualty insurance agents from all 50 states, Puerto Rico and the Virgin Islands, and with headquarters in Washington, D.C.

With me today is Edward H. O'Rourke, an agent from Louisville, Kentucky, and a member of PIA's State Legislation and Regulation Committee. He is also a member of the Board of Directors of the Kentucky Insurance Guaranty Association and is appearing with me today because of his first-hand knowledge of the regulation of insurers for solvency in his state.

PIA has consistently supported the state regulation of the business of insurance. We feel that regulation at this level is well suited to the diversity of insurance carriers operating in this country -- large national insurers, regional insurers, small insurers which serve only one or relatively few states. Furthermore, and more important, we believe that the regulation most responsive to the needs of insurance buyers is that which is closest to them, namely, regulation at the state level. Our association has also supported, and continues to support, state post-assessment guaranty funds as the means of dealing with insurer insolvencies.

In S. 1710, the "Federal Insurance Act of 1977," we are faced with a proposal to establish a federal chartering option as an alternative to state supervision and a federal guaranty fund to deal with insolvencies of both federally-chartered insurers and those state-chartered insurers which subscribe to it. In short, the proposal would create a dual regulatory system for the insurance industry.

S. 1710 is a detailed and complex bill which would bring about profound changes in the operation of a vital segment of our economy. A thorough analysis of its provisions, and detailed comments on them, is beyond the scope of this statement. Our intention is to focus on the two basic concepts, the federal chartering option and the federal guaranty fund, rather than the many particulars of the legislation.

In his remarks upon introducing S. 1710, Senator Brooke stated that he had made certain modifications in this bill since the earlier version was introduced in the last Congress, and that he expected further modifications to be made as comments were received on it. The position of our association is that no modification can

make this bill acceptable, since its two basic concepts are themselves not in the best interest of either the insurance industry or the public which it serves.

In considering this proposal, we must recognize that it also entails another significant change in the regulation of the business of insurance in that federally-chartered insurers would lose the antitrust immunity granted under the McCarran-Ferguson Act. Therefore, any discussion of S. 1710 must also include a consideration of the effects of application of the federal antitrust laws to the insurance industry. For the moment, however, let us set aside this consideration and deal with our objections to the federal charter and federal guaranty fund proposals per se.

First, there is the matter of the cost of supporting two separate regulatory systems. While the bill makes it clear that federally-chartered insurers would be exempt from state regulation regarding the establishment and maintenance of reserves, investment practices, participation in state guaranty funds, and state regulation of rates and risk classification (except for residual market mechanisms), such insurers would still be subject to state regulation relating to coverage forms, minimum coverage requirements, cancellation and renewal requirements and other aspects of the state's insurance regulation which are not specifically exempted in Section 204 of the bill. In other words, all federally-chartered insurers would be subject to some regulation at both the state and federal level, while state-chartered insurers would continue to be subject to all aspects of state regulation as they are now. This proposal would not seem to diminish the cost of state regulation significantly, other than perhaps through what staff reductions in examiners or actuaries could be effected, while it would entail the additional

cost of supporting the federal regulatory system.

We have seen no estimate of what the additional cost of the federal regulatory mechanism would be. We can, however, point to the fact that for the year ending December 31, 1974, the various states spent approximately \$92 million in the regulation of the insurance industry. It is generally conceded that many state insurance departments are under-funded and under-staffed to properly perform the task of solvency regulation and that even more should be spent. Clearly, the cost of an additional layer of regulation will be substantial, and it must be determined whether the benefits justify the cost.

In the case of state regulation, the cost of the regulatory mechanism is paid from the premium taxes levied on insurance companies. Ultimately, of course, the insurance buyer bears the cost since an allowance for taxation is built into rates. Under the provisions of S. 1710, the states retain their right to tax insurers, both federally-chartered and state-chartered. The assessments paid by federally-chartered insurers to the federal guaranty fund, according to Section 102(c), are to be used to meet the obligations of insolvent insurers and the expenses of the Federal Insurance Commission in carrying out its functions. Companies operating under a federal charter can be expected to build an allowance for the assessments into their rates. Thus, policyholders of federally-chartered insurers would pay the cost of both state and federal regulation.

In addition to the cost consideration, we feel that the federal charter option could have an adverse effect on smaller companies, which would lead to increased concentration of the insurance business in the hands of the large national carriers and a

resultant lessening of competition. The severe and well publicized problems with rigid state regulation in some states and the prospect of no rate regulation at the federal level would be an inducement to seek a federal charter. The expense savings involved in not having to make rate filings and financial reports in all states in which the carrier operates would be an added inducement. It seems inevitable that over the long term there would be a movement towards federal chartering because of these perceived advantages, particularly among the large national carriers.

The smaller carriers, especially those which operate in only one or a few adjoining states, would be those most likely to choose to remain under state regulation since they are closer to the state regulatory authorities. Not all carriers would be able to obtain a federal charter since they must meet not only the investment requirements of Section 205 of the bill, but also any rules regarding minimum amounts of capital and surplus (for stock insurers) or guaranty fund (for other than stock insurers) which may be promulgated by the Federal Insurance Commission under Section 202. Clearly some insurers would be excluded from participation in the federal regulatory scheme, most likely the smaller carriers. These companies could be placed at a competitive disadvantage in relation to the larger, federally-chartered carriers, with the result being an increase in the flow of business to the latter companies.

S. 1710 provides for all federally-chartered insurers to participate in the federal guaranty fund. State-chartered insurers may elect to participate in it. However, in the case of the latter, if the Federal Insurance Commission is not satisfied that the particular state's regulations provide the minimum protection deemed essential for participation in the fund, it can, under

Section 103, require the state-chartered insurer to meet standards established by the Commission. Obviously the burden of the state guaranty funds would fall on those state-chartered insurers which do not choose, or cannot qualify, for participation in the federal guaranty fund. While it can be argued that these companies would face a considerably reduced risk, since they would not be affected by a major insolvency of a federally-chartered carrier, it is still possible that the insolvency of one or more state-chartered insurers could significantly impair the financial condition of the others and perhaps force some of them out of the market.

In his remarks upon introducing S. 1710, as well as in other public statements, Senator Brooke pointed to the similarity of his proposal to the dual regulatory system under which banks operate. The implication is that what has worked well for banking should work well for insurance too. Setting aside the significant differences between banking and insurance, we must ask: "How well has federal regulation performed in the field of banking?" According to the recently released General Accounting Office study, "Federal Supervision of State and National Banks," the results have been mixed to say the least. Under effective federal regulation, how could two such massive insolvencies as U.S. National Bank and Franklin National Bank have occurred? We see no reason to assume that federal regulation will automatically improve the quality of regulation for solvency in the insurance industry.

These considerations alone would be sufficient to lead us to view with caution the federal charter/federal guaranty fund proposal. When coupled with considerations relating to the loss of antitrust immunity accompanying the federal charter option, we have no choice but to oppose it.

At this point in our statement it is appropriate to refer to a document emanating from the Executive Branch, namely the Justice Department Report to the Task Group on Antitrust Immunities entitled "The Pricing and Marketing of Insurance." Since this report also incorporates a proposal for a federal charter option and a federal guaranty fund, it is inevitable that it will form part of the framework of any discussion of the provisions of S. 1710.

While the Justice Department began its study with a concern over the effect of the insurance industry's antitrust immunity on competition, and Senator Brooke began with a concern over regulation for solvency, each has concluded by recommending the federal charter/federal guaranty fund approach as the means of dealing with these individual concerns.

While neither the Justice Department Report nor S. 1710 recommends repeal, or even amendment, of the McCarran-Ferguson Act, each proposes that federally-chartered insurers give up the antitrust immunity granted by that act. This is made clear in the case of the proposed legislation by Section 109 of the bill. Thus it becomes necessary to consider what the effect of the loss of antitrust immunity would be and, more specifically, what the effect would be of one portion of the industry enjoying antitrust immunity while the remaining portion is subject to full application of the federal antitrust laws.

The most immediate and pervasive impact of removal of the antitrust exemption would be in the area of insurance pricing. Simply put, federally-chartered companies could no longer make, file or adopt rates collectively. The role of rating bureaus would be greatly diminished in that the bureau would have to conform to federal antitrust standards for the exchange of cost information.

This could take the form of collection of past loss and expense data, and formulation of standard statistical plans.

The Justice Department Report states an opinion that antitrust precedent would permit the joint performance of these functions so long as the bureau is an independent advisory organization and not operated by the insurance companies themselves. The Department feels that any joint prediction of future rates would be prohibited under the Sherman Act, which would mean that the trending function would have to be assumed by another entity, either the individual carrier itself or an outside source such as a private consulting actuarial firm. In other words, federally-chartered companies which had previously depended on bureau rates would be put in the position of having to obtain pure loss and expense data from the bureau and then perform themselves (or have performed for them on an individual basis) the trending function and the introduction of the company expense and profit factors in order to arrive at the final rates which they would charge.

It is clear that such a situation would require significant changes in rating bureau operations as they exist in the industry today. Basically, each bureau would have to choose to constitute itself and shape its operations so as to serve either federally-chartered carriers or state-chartered carriers, or, in effect, split itself into two different types of organizations which would be able to perform the functions appropriate to and permissible for the two different types of carriers.

It is inevitable that additional administrative costs would be involved in such a system as well as the additional cost for federally-chartered carriers which previously relied on bureaus for their ratemaking and filing activities.

For those smaller companies which might elect a federal charter, it is apparent that they would feel a substantial impact if their prior practice had been subscription to a bureau for the making and filing of rates. Their expenses would undoubtedly increase. The impact would be felt far less by companies that have the actuarial capability and sufficiently credible data base to develop their own rates and those that presently do their pricing independent of the bureaus. Some smaller companies could find that the federal charter option is not a viable alternative for them because of their inability to assume the ratemaking and filing roles, either through the lack of a sufficiently credible data base or because of the expense involved.

It is possible that some smaller companies could be forced to withdraw from the marketplace. There is also a question as to whether state-chartered carriers could collectively produce a credible data base for bureau ratemaking if the larger carriers accounting for the major part of the nation's premium volume chose to become federally-chartered.

Again referring to the Justice Department Report, we find the opinion that removal of antitrust immunity would not affect the industry's voluntary risk-sharing arrangements, such as reinsurance contracts and participation in pooling mechanisms, which are either "necessary to the conduct of business (and reasonably structured) or provide significant economies of operation without lessening actual or potential competition." Under a system in which some carriers enjoy antitrust immunity while other carriers do not, however, we must ask what would be the status in relation to the antitrust laws of pooling mechanisms which are composed of both federally-chartered and state-chartered carriers. It seems clear

that the least that can be expected is a considerable amount of confusion.

It should also be noted that we have only the opinion of the Justice Department's Antitrust Division that bureau development of pure loss premiums and risk pooling arrangements would be permissible under the antitrust laws. This is no guarantee that such arrangements would not be challenged by parties outside the Justice Department. In short, federally-chartered carriers would be sailing uncharted waters with respect to the antitrust laws. Similarly, agents would face different situations with regard to the different types of carriers which they represent. Presumably, agents would be exempt from the federal antitrust laws insofar as they were representatives of state-chartered insurers, but subject to them insofar as they were representatives of federally-chartered insurers. Ordinary care would seem to dictate that an agent who represents even one federally-chartered insurer operate as if he represented only federally-chartered insurers.

It seems unavoidable that the conflicting demands of two distinct systems of regulation existing side-by-side would lead insurers to gravitate toward either one or the other. Similarly, agents would be inclined to move toward exclusive representation of either federally-chartered or state-chartered carriers. If the larger national carriers move towards the federal regulatory option in significant numbers, the remaining small state-chartered companies would be only a vestige of the state level insurance mechanism which we know today. Ultimately, they could be forced out of the business altogether.

While S. 1710 provides for no regulation of insurance pricing of federally-chartered insurers, it seems naive in the extreme to

believe that the Federal Insurance Commission could long remain aloof from the pricing practices of the carriers under its supervision. Given the significant increase in insurance costs over the past few years, as a result of inflation, and the inevitable pressures which would be exerted by the public through its elected representatives and consumer groups, it is probable that the Commission would shortly find itself involved in the regulation of rates of federally-chartered carriers, rather than relying solely on enforcement of the federal antitrust laws.

Section 109 of the bill states that the Commission shall not adopt any rule or regulation or exercise any other authority so as to impose a burden on competition which is not necessary or appropriate to the purposes of the act and in any event, shall adopt the least anticompetitive alternative to protecting policyholders and the public interest. There would seem to be nothing here prohibiting rate regulation by the Commission should that be deemed the least anticompetitive alternative to protecting the public interest. If such regulation were performed primarily to hold down rates to what is considered an affordable level, as has been the case in a few states, the severe disruption of the market and aggravated availability problems which have occurred in those states could occur on a national level.

We recognize that it is not the intention of this legislation, according to Senator Brooke's public remarks, to provide rate regulation of federally-chartered insurers. However, federal agencies have been known to disregard Congressional intent in carrying out what they perceive to be their functions, as is witnessed by the recent attempt of the Federal Insurance Administration to assume operational control of the National Flood Insurance Program

by regulation and to reduce the role of its industry association partner to that of a mere fiscal agent. Should the Federal Insurance Commission set up by S. 1710 become the heir to the philosophy embodied by the present FIA, the result could be even more federal control over the insurance mechanism because of the greater authority of the newly-constituted agency.

It is the opinion of our association that the combined effect of the considerations discussed thus far, those relating solely to the federal charter/federal guaranty fund proposal and those relating to the loss of antitrust immunity, would be the demise of state regulation of insurance. We realize that Senator Brooke has stated on several occasions that it is not the intent of the bill to substitute federal for state regulation, but merely to provide an option. We suspect, however, that regardless of the intent, this is the probable result. It seems to us that the proposed legislation would operate to the disadvantage of smaller carriers, would lead to increased concentration of the insurance business in the hands of large national companies, would unnecessarily split the industry into two segments, would result in confusion for all segments of the industry, as well as for the public which it serves, and, over the long term, would bring about the gradual replacement of the state regulatory system with a system of total federal regulation.

The objections which we have made to the legislation under consideration by the Committee should not be interpreted as meaning that we are defending the status quo in the state regulation of insurance. Considering the record of regulation by the states, there is no doubt that there is room for improvement. We do not feel, however, that federal legislation in this area, and the establishment

of a federal regulatory mechanism and federal guaranty fund, is the preferred method of dealing with the problems which exist in state regulation. These problems can and should be dealt with at the state level.

Many of the problems relating to insurance prices and insurance availability in particular states are primarily political in origin. Such problems are best solved through the cooperative effort of the people of the state, through their elected state legislators, the insurance industry and the regulatory authority.

It is clear that some changes should be made in the state guaranty fund laws in order to better prepare them to respond to insurer insolvencies. At the most recent meeting of the National Association of Insurance Commissioners (June 1977) PIA urged the NAIC to study various suggestions which had been put forward to improve their Post-assessment Property and Liability Insurance Guaranty Association Model Act. Among these were immediate access to the assets of the insolvent company, prior creditor status for the guaranty association and a provision to offset guaranty fund assessments against insurers' premium taxes. These proposals have also been made by other insurance trade associations and several states have acted to improve their guaranty fund laws accordingly.

According to the National Committee on Insurance Guaranty Funds, there are now 18 states with laws allowing guaranty funds immediate access to the assets of an insolvent insurer. Sixteen states have laws giving guaranty funds priority over general creditors for those assets and 11 states have provisions for premium tax offsets for assessments paid by member insurers to guaranty funds.

While such improvements should increase the ability of the state guaranty funds to respond to insolvency situations, there can be no doubt that the best method of dealing with the insolvency problem is to prevent insolvencies from occurring. PIA has for some years supported improved regulation for solvency at the state level through the return of more of the premium tax collected by the state to the operating budget of the insurance department so that it can be adequately staffed to carry out its primary regulatory responsibility.

We also feel that there is another method of improving the quality of solvency regulation which deserves serious consideration by the various states. This involves the active participation of the guaranty association members in assisting the insurance department to monitor the companies under its charge. Such an approach is used in Kentucky and has been successful there.

Mr. O'Rourke has prepared a statement describing the performance of this function by the Kentucky Insurance Guaranty Association in some detail. This statement is submitted as Appendix A to the full PIA statement.

In closing we would note that the statement by Senator Brooke in introducing S. 1710 indicated that the concerns which led to this proposed legislation were the poor financial condition of the property-casualty industry as a result of the record losses suffered in 1974 and 1975 and the possibility of a major insurer insolvency, such as nearly occurred in the case of GEICO last year.

Since the time the original draft of this bill was introduced in the last Congress, the operating results of the property-casualty industry have shown encouraging improvement and there are no prospects of a major insurer insolvency at this time. The experience of the

past two years, which so concerned Senator Brooke, has also concerned the industry, state legislatures and state regulatory authorities so that steps have been taken and are being taken at the state level to improve the quality of regulation and the guaranty fund laws.

It should be clear from our statement that PIA believes that with respect to property-casualty insurance, the public is best served by an industry composed of many diverse carriers competing vigorously under state regulatory authority. We view with alarm any proposal which would tend to lead to greater concentration in the industry, which would move regulation farther away from the people most directly affected by it and which would impose an additional cost burden on the insurance buying public. In short, we feel that S. 1710 is unnecessary legislation and not in the best interest of the public. For this reason, we respectfully urge the Committee to take no affirmative action with respect to it.

Mr. Chairman, this concludes the statement of position of the Professional Insurance Agents in regard to S. 1710, the "Federal Insurance Act of 1977." We appreciate the opportunity to express our views to the Committee. Mr. O'Rourke and I will both be happy to respond to any questions.

APPENDIX A
TO
STATEMENT BY MARVIN L. PEARCE
OF
~~THE PROFESSIONAL INSURANCE AGENTS~~
CONCERNING S. 1710
THE "FEDERAL INSURANCE ACT OF 1977"

Statement On
The Kentucky Insurance Guaranty Association

BY

EDWARD H. O'ROURKE, CPCU,
Member of the Professional Insurance Agents and
Member of Board of Directors of
The Kentucky Insurance Guaranty Association

A properly constituted and operated guaranty association should protect the consumer and the insured public in the event of insurer insolvency but, of equal importance, should further protect the consumer by detecting and preventing insurer insolvency. The Kentucky Insurance Guaranty Association was constituted to perform this dual function by the enactment of Subtitle 36, K.R.S., Chapter 304, on March 2, 1972. Lines 7 through 13 of that act stated its purpose in these words:

"The purpose of this Subtitle is to provide a mechanism for the payment of covered claims under certain insurance policies to avoid excessive delay in payment, and to avoid financial loss to claimants or policyholders because of the insolvency of an insurer to assist in the detection and prevention of insurer insolvencies and to provide an association to assess the cost of such protection among insurers."

Since its inception, the Kentucky Insurance Guaranty Association has had to respond to three insurer insolvencies. To do this, it has assessed all companies .0016% of their 1975 premiums written, which amounted to \$1,044,904.48. Over 1,400 policyholders and covered loss claimants have been processed by the Kentucky Insurance Guaranty Association. To these members of the consumer public, this well constituted and operated state guaranty fund proved to be a Godsend.

Of equal or more importance to the public has been the function of the association in its other major duty, which is spelled out in the act in the following words:

"It shall be the duty of the Board of Directors, upon majority vote, to notify the commissioner of any information indicating any member insurer may be insolvent or in a financial condition hazardous to the policyholders or the public. The Board of Directors may, upon majority vote, request that the Commissioner order an examination of any member insurer which the Board in good faith believes may

be in a financial condition hazardous to the policyholders or the public. Within thirty (30) days of the receipt of such request, the Commissioner shall begin such examination. It shall be the duty of the Commissioner to report to the Board of Directors when he has reasonable cause to believe that any member insurer examined or being examined at the request of the Board of Directors may be insolvent or in a financial condition hazardous to the policyholders or to the public. The Board of Directors may, upon majority vote, make a report and recommendations to the Commissioner upon any matter germane to the insolvency, liquidation, rehabilitation or conservation of any member insurer. The Board of Directors may, upon majority vote, make recommendations to the Commissioner for the detection and prevention of insurer insolvencies."

The Board has been most active in the exercise of the duty of detecting and preventing insurer insolvency. We have reviewed and monitored as many as 40 companies over the past several years and requested commissioner action in a number of cases. By the exercise of this duty, we believe the Kentucky Insurance Guaranty Association has saved the consumer public of our state, as well as the insurers doing business in our state, much time, effort and money.

The "Plan of Operation" of the Kentucky Insurance Guaranty Association provides for a Board of Directors, consisting of seven members plus the Commissioner of Insurance who serves ex officio. Representation is required from the following industry classes:

1. Insurance companies which are members of the American Insurance Association.
2. Insurance companies which are members of the Alliance of American Insurers (formerly American Mutual Insurance Alliance).
3. Insurance Companies which are members of the National Association of Independent Insurers.
4. Foreign insurance companies not affiliated with any trade association.
5. Licensed, resident, general lines insurance agents by a representative who holds membership in either the Independent Insurance Agents of Kentucky, Inc. or the Professional Insurance Agents of Kentucky, Inc. and who represent no less than three qualified insurers,

which are not affiliated in any way and are not operating under the same general management.

6. Insurance companies domiciled in the Commonwealth of Kentucky by two persons, one of whom shall be a regularly licensed and practicing attorney at law in the Commonwealth of Kentucky, and shall serve as Counsel to the Board.

A guaranty association, so constituted and consisting of such representation on a statewide basis, provides the maximum protection to the public. The performance of the Kentucky Insurance Guaranty Association has been proven in fact over the five years of its existence.

The strength of this successful guaranty association is found in the responsiveness of its members at the state level. It is a manageable, responsive mechanism and has been proven so. It is speculative, at best, that the same manageability and responsiveness could be obtained at a federal level.

A system of dual guaranty associations would harm the present system in our state, in that the federal guaranty fund would have the large insurers as members, thus depriving the state of needed assessments to respond to insolvencies. In addition, this dual system could be the deathknell to small and regional insurers whose surplus condition could not stand a sizable assessment needed to respond to the insolvency of another regional insurer. The dual system would leave the citizens of my state with a weakened guaranty association with limited assessment potential and a far-removed federal regulatory authority which would be much less responsive to Kentucky and upon which Kentucky would probably have no representation.

I doubt that much support could be found among the citizens in my state for such a system.

DEPARTMENT OF INSURANCE,
Frankfort, Ky., September 7, 1977.

MEMORANDUM

To: Hon. William Proxmire, Chairman, Banking, Housing, and Urban Affairs
Committee of the U.S. Senate.

From: Harold B. McGuffey, Commissioner of Insurance, Commonwealth of
Kentucky.

Re Kentucky Insurance Guaranty Association.

Mr. Edward H. O'Rourke, CPCU, agent from Louisville, Kentucky, informs me that he will appear before your Committee on September 14, 1977.

For the record, Mr. O'Rourke has asked me to comment briefly on the effectiveness of the Kentucky Insurance Guaranty Association, of which he is a member.

The Kentucky Insurance Guaranty Association, directed by a small group of insurance people who give their time voluntarily, has worked well with the Department of Insurance. The Association has, in its five years of existence, responded with alacrity to three insurance company insolvencies. Without fanfare, they assessed their membership for funds to assist hundreds of policyholders and claimants.

Perhaps equally important, the Association keeps an "eagle eye" out for financial problems of any member insurer. The Association and the Insurance Department work together on this, thus averting potential insolvencies.

It is my opinion and the opinion of this Department that the Kentucky Insurance Association is well constituted and operating in the best interests of the people of Kentucky.

Mr. PEARCE. PIA has consistently supported the State regulation of the business of insurance, because of the diversity of insurance carriers operating in this country—large national insurers, regional insurers, and small insurers which serve only one or relatively few States.

Our association has also supported and continues to support State postassessment guarantee funds as a means of dealing with insurer insolvency.

In S. 1710, the Federal Insurance Act of 1977, we are faced with a proposal which would create a dual regulatory system for the insurance industry.

This is a detailed and complex bill, which would bring about profound changes in the operation of a vital segment of our economy.

A thorough analysis of its provisions and detailed comments on them is beyond the scope of my statement.

Our intention is to focus on the two basic concepts, the Federal chartering option, and the Federal guarantee fund, rather than the many particulars of the legislation.

The position of our association is that no modification can make this bill acceptable since its two basic concepts are not in the best interests of either the insurance industry nor the public which it serves, because of what we term the three C's cost: concentration, and confusion.

Let's first consider the matter of the cost of supporting two separate regulatory systems. All federally chartered insurers would be subject to some regulation at both the State and Federal levels, while State chartered insurers would continue to be subject to all aspects of State regulation as they are now.

This proposal would not seem to diminish the cost of State regulation significantly, while it would entail the additional cost of supporting the Federal regulatory system.

We have seen no estimate of what the additional cost for the Federal regulating mechanism would be, but it is clear that the cost of an additional layer of regulation would be substantial, and it must be determined whether the benefits justify the costs.

In considering this proposal, we must recognize it also entails another significant change in the regulation of the business of insurance, in that federally chartered insurers would lose the antitrust immunity granted under the McCarran-Ferguson Act.

Therefore, any discussion of S. 1710 must also include a discussion of the effects of the application of the Federal antitrust laws to the insurance industry.

The most immediate and pervasive impact of removal of the anti-trust exemption would be in the area of insurance pricing. The role of the rating bureaus would be greatly diminished. Federally chartered companies which had previously depended on bureau rates would be put in the position of having to obtain pure loss and loss adjustment expense data from the bureau, and then perform themselves or have performed for them on an individual basis the trending function and the introduction of the company expense and profit factors, in order to arrive at the final rates they would charge.

It is inevitable that additional administrative costs would be involved in such a system, as well as the additional cost for federally chartered carriers which previously relied on bureaus for the rate-making and filing activities.

In addition to the cost consideration, we feel that the Federal charter option could have an adverse effect on smaller companies, which would lead to increased concentration of the insurance business in the hands of the large national carriers, and a resultant lessening of the competition.

We expect that over the long term there would be a movement toward Federal chartering by the large national carriers. The smaller carriers, especially those which operate in only one or a few adjoining States, would be most likely to choose to remain under State regulation. These companies would be placed at a competitive disadvantage in relation to the larger federally chartered carriers, the result being an increase in the flow of business to the latter companies.

S. 1710 provides for all federally chartered insurers to participate in the Federal guaranty fund. State chartered insurers may apply to participate in it. Obviously the burden of the State guaranty funds would fall on those State chartered insurers which do not choose or cannot qualify for participation in the Federal guaranty funds.

While it can be argued that these companies would face a considerable reduced risk, since they would not be affected by a major insolvency of a federally chartered carrier, it is still possible that the insolvency of one or more State chartered insurers could significantly impair the financial condition of the others, and perhaps force some of them out of the market, thus tending to further the concentration of business in fewer companies.

As President of an association representing more than 30,000 dues paying members, I have to be concerned with the confusion S. 1710 would bring to our membership. In a recent interview, Senator Brooke, when asked the question, "Will the Sherman, Clayton, and

Federal Trade Commission Acts apply to insurance agents of federally chartered insurers?" He replied, "Yea." We would assume agents, therefore, would face different situations with regard to the different type of carriers which they represent. They would be exempt from the Federal antitrust laws insofar as they were representatives of State chartered insurers, but subject to them insofar as they were representatives of federally chartered insurers.

It seems unavoidable that the conflicting demands of two distinct systems of regulation existing side by side will lead insurers and agents to gravitate to either one or the other.

As far as the insurance companies are concerned, under a system in which some carriers enjoy antitrust immunity, while other carriers do not, we must ask what would be the status in relation to the antitrust laws of pooling mechanisms, composed of both federally and State chartered carriers? It seems clear the least that can be expected is a considerable amount of confusion. While S. 1710 provides for no regulation of insurance pricing of federally chartered insurers, it seems naive in the extreme to believe that the Federal Insurance Commission could long remain aloof from the pricing practices of the carriers under its supervision.

Given the significant increase in insurance costs over the past few years, as a result of inflation and the inevitable pressures which would be exerted by the public through its elected representatives and consumer groups, probably the Commission would shortly find itself involved in some regulation of rates of federally chartered carriers rather than relying solely on enforcement of the antitrust laws.

If such regulation were performed primarily to hold down rates to what is considered an affordable level, as has been the case in a few States, a severe disruption of the market and aggravated problems which have occurred in those States could occur on the national level.

It is the opinion of our association that the combined effect of the considerations discussed thus far would be the demise of State regulation of insurance.

We realize it is not the intent of the bill to substitute Federal for State regulation, but merely to prove an option. We suspect, however, that regardless of the intent, this is the probable result.

It seems to us that the proposed legislation would operate to the disadvantage of smaller carriers, would lead to increased concentration of the insurance business in the hands of large national companies, would unnecessarily split the industry into two segments, would result in confusion for all segments of the industry, as well as for the public which it serves, and over the long term would bring about the gradual replacement of the State regulatory system with a system of total Federal regulation.

The objections which we have made to the legislation under consideration by the committee should not be interpreted as meaning that we are defending the status quo in the State regulation of insurance. Considering the record of regulation by the States, there is no doubt that there is room for improvement. We do not feel, however, Federal legislation in this area and the establishment of a Federal regulatory mechanism and Federal guaranty fund is the preferred method of dealing with the problems which exist in State regulation. These prob-

lems can and should be dealt with at the State level. It is clear that some changes should be made in the State guaranty fund laws, in order to better prepare them to respond to insurers' insolvency.

Various suggestions have been put forward, including immediate access to the assets of the insolvent company, prior credit status for the guaranty association, and a provision to offset guaranty funds assessments against insurers' premium taxes and several States have acted to improve their guaranty funds laws accordingly.

While such improvements should increase the ability of State guaranty funds to respond to such situations, the best method of dealing with the insolvency problem is to prevent insolvency from occurring.

PIA has supported improved regulation for insolvency at the State level through the return of more of the premium tax collected by the State to the operating budget of the insurance department, so it can be adequately staffed to carry out its primary regulatory responsibility.

We also feel there is another method of improving the quality of solvency regulations, which deserves serious consideration by the various States. This involves the active participation of the association members in assisting the insurance department to monitor the companies under its charge. Such an approach is used in Kentucky and has been successful there.

Mr. O'Rourke has prepared a statement describing the performance of this function by the Kentucky Insurance Guaranty Association in some detail. This statement is an appendix to my full statement.

Mr. Chairman, this concludes the statement of position of the Professional Insurance Agents in regard to S. 1710. We appreciate the opportunity to express our views to the committee.

Mr. O'Rourke and I will be happy to respond to any questions you may have.

The CHAIRMAN. Thank you very much.

Mr. Kremer.

STATEMENT OF EDWARD J. KREMER, CHAIRMAN, FEDERAL AFFAIRS COMMITTEE, INDEPENDENT INSURANCE AGENTS OF AMERICA, ACCOMPANIED BY JEFFERY YEATES, ASSOCIATE GENERAL COUNSEL

Mr. KREMER. Thank you, Mr. Chairman. My name is Edward J. Kremer, and I am chairman of the Federal affairs committee of the Independent Insurance Agents of America, Inc.

I am accompanied today by our associate general counsel, Jeffery Yeates.

[The statement read by Mr. Kremer follows:]

Statement of

EDWARD J. KREMER
CHAIRMAN OF THE FEDERAL AFFAIRS COMMITTEE
OF THE
INDEPENDENT INSURANCE AGENTS OF AMERICA, INC.,

before the

COMMITTEE ON BANKING, HOUSING AND
URBAN AFFAIRS

of the

UNITED STATES SENATE

on S. 1710

September 14, 1977

Mr. Chairman and Members of the Committee:

My name is Edward J. Kremer and I am Chairman of the Federal Affairs Committee of the Independent Insurance Agents of America, Inc. ("IIAA"). We welcome this opportunity to present our views concerning the proposed Federal Insurance Act of 1977 (S. 1710) ("Act"). Title I of the Act would create a Federal insurance program whereby guarantee would be provided to insurance obligations. Title II would provide a Federal

chartering alternative for insurance companies similar to the Federal chartering alternatives available to banks and savings and loan associations under the current system of dual regulation of financial institutions.

I. Introduction

IIAA is a national association of independent property and casualty insurance agents. The association is composed of 51 state associations (including the District of Columbia) which represent more than 34,000 insurance agencies representing approximately 126,000 insurance agents across the country. IIAA's member agencies vary in size. Most are small businesses having gross incomes of less than \$60,000 per year. The agents are proud of being part of an industry where small business organizations have been able effectively to serve the insurance needs of the public.

Our industry is highly complex and diverse. There exist large and small insurance companies which do business in a variety of ways. Some sell their products by mail. Others use salaried employees. Still others operate through independent agents such as those who are members of IIAA.

In light of the complexity and the competitiveness of the insurance industry, any legislative proposal which would radically restructure the industry should be approached with

great care. IIAA is concerned that the Federal Insurance Act of 1977 has the potential of seriously undermining the present competitive structure of the property and casualty insurance industry. Furthermore, the Act carries with it this danger without necessarily affording the insurance consuming public the increased measure of protection the legislation intends to provide. Finally, the Act would establish another tier of government involvement in an industry which is already highly regulated. For these reasons, IIAA opposes the proposed legislation.

In this testimony we will provide a brief description of the structure of the property and casualty insurance industry and the role played by the agent in it. We will also briefly summarize some of the reasons why we believe the Act would not provide the public protection it is designed to achieve. We will also explain some of the possible effects that the Act would have upon the marketing (as opposed to the underwriting) sector of the industry. Finally, we will suggest various regulatory alternatives that we believe would better address the problems currently presented in the insurance industry.

II. Overview of the Property and Casualty Insurance Industry

Before discussing the possible effects of the Act on the property and casualty insurance industry and the public that industry serves, a brief overview of the industry and how it operates is appropriate.

1. Description of the Industry

The insurance business may roughly be divided into three broad categories: (i) life insurance, (ii) health insurance, and (iii) property and casualty insurance. There are a total of approximately 5,000 insurance companies selling these various types of insurance. The property and casualty insurance industry is comprised of approximately 2,900 insurance companies selling fire, automobile, general liability, worker's compensation, inland marine, ocean marine, homeowners, fidelity, and crime insurance. In addition, some insurance underwriters also offer surety bonds. The total premium volume for the industry in 1975 amounted to slightly less than \$50 billion dollars.

From many points of view, the most important person in the entire insurance transaction is the agent. The agent works with the insurance consumer to establish the necessary coverages by type and magnitude through an analysis of the consumer's economic circumstances and existing insurance portfolio (if any). The agent is also a valuable link in the claims process should the need arise. In recognition of the important role played by the agent in the insurance distribution process, the marketing mechanisms of the industry generally revolve around him. The industry has evolved several marketing systems, each of which uses agents somewhat differently. However, each system has as its goal the attainment of efficiency and the distribution and servicing of the insurance product.

In the property and casualty insurance field, insurance underwriters either market their product through the American agency system (independent agents) or through so-called captive agents (direct writers). Independent agents generally represent several companies, dividing their policies among those companies in accordance with their client's choice based on consultation with the agent. An independent agent "owns his expirations," which means that, if his client so chooses, at the time the policies expire, the independent agent may place the renewal of such policies with an insurer different from the original company. On the other hand, "direct writing" companies operate through (i) the mail, (ii) salaried representatives, or (iii) exclusive agents. The compensation to direct writer salesmen may be in the form of salary or, perhaps, through commissions, based on premium volume. Unlike their independent agent counterparts, direct writer salesmen do not own the expirations and cannot place insurance with another company.^{1/}

^{1/} Another facet of the marketing mechanism of the property and casualty insurance industry is the insurance broker. Unlike the insurance agent, the broker solicits business from his clients and then places that business with insurers. While the broker is the agent of the insurance consumer, he normally receives his compensation (commissions) from the insurance companies.

2. Role of the Agent

Not only are there differences between insurance companies which use independent agents and those which are direct writers, but there are also differences among independent agencies themselves. The average independent agency is a small competitor employing as few as six people who perform all of the operations of the agency. Other agencies are large firms which sell insurance on a national, or even an international, basis and employ hundreds of people who perform highly specialized functions. Some agents specialize in the sale of personal lines insurance (insurance sold to individuals and households), while others specialize in the sale of commercial lines (insurance sold to commercial enterprises). Most agencies, however, operate to some degree in both markets.

No one knows for certain how many independent agencies exist in the country. The Insurance Information Institute estimates that there were about 350,000 persons engaged in the agency and brokerage field at the end of 1974, but this figure includes company agents and exclusive agency company representatives. IIAA estimates that the total number of agencies in the country is approximately 75,000 -- all differing in size, the types of accounts that they handle, profitability, and marketing strategy.

Insurance agents compete primarily on the basis of the quality of services they provide to the public. The price

of the insurance is a factor which is usually outside of the control of the agent. Price competition between agencies does take place, but this price competition is based on the price competition between the companies that the agencies represent.

In addition to being a complex subject, insurance requires specific knowledge that is beyond the experience of most consumers. For that reason, the ability of a professional insurance agent to advise insurance purchasers on coverages, costs, and insurance underwriters is of tremendous value to the consumer. In addition, in the event of loss, the assistance which an independent insurance agent may render the consumer in connection with his insurance claim could be invaluable. It is for these reasons, that the glorification of the price of insurance to the virtual exclusion from consideration of the economic value to the consumer of independent insurance advice is unwise and, in a legislative context, could work positive harm on the insurance consuming public.

3. Role of the State Regulator

Insurance is currently regulated by the various states. State insurance regulators have a dual role. The public tends to think of the insurance regulator's task in terms of preventing insurers from exploiting the consumer. While this is certainly an important regulatory function, insurance regulators must also prevent the establishment of insurance rates which are so

inadequate as to impair the ability of companies to pay their claims.^{2/} In other words, regulators are also responsible for assuring the solvency of the insurance underwriters doing business within their jurisdictions. They seek to assure that the public has access to viable insurance companies which are able to provide adequate insurance services to the public.

There is no question that the Act contemplates a radical restructuring of the current property and casualty insurance regulatory scheme. Such radical changes in regulatory structure of the industry will inevitably impact the industry's market structure.

III. Analysis of the Act and Its Implications

1. Summary of the Act

The Act would establish an independent agency entitled the Federal Insurance Commission ("Commission"). The Commission would be responsible for the administration of the Federal Insurance Guaranty program established by the Act. Title I of the Act would establish a fund made up of fees paid by insurance companies whose obligations are guaranteed by the Commission. With respect to the fund, the Commission would be authorized to issue Federal guarantee certificates to any insurer, whether State-chartered or Federally-chartered, which makes applications and meets the requirements of the Commission. Under Section 103

^{2/} Further, insurance regulators are required to assure that insurance rates are not excessive or unfairly discriminatory.

of the Act, any Federally-guaranteed insurer, whether Federally-chartered or State-chartered, would be exempt from contributions to any State insolvency fund. Section 109 of the Act would leave in place the Federal antitrust immunities provided by the McCarran-Ferguson Act, but would remove those immunities with respect to Federally-chartered insurers. Title II of the Act sets forth the procedures and regulatory mechanism for the establishment and regulation of Federally-chartered insurance companies.

2. The Act May Be Self-Defeating

Traditionally, the insurance industry has been regulated principally by the state and not the Federal government. Furthermore, state regulation of insurance has long been recognized by the Congress as being "in the public interest."^{3/} IIAA submits that, unless very compelling reasons can be shown to justify a departure from state regulation, such regulation should be preserved and strengthened where appropriate. For its part, the Act takes a completely opposite approach and is therefore objectionable. Indeed, if enacted, the Act has the potential of having an opposite effect from what it intends. Several examples will illustrate the point.

^{3/} See McCarran-Ferguson Act of 1945, 15 U.S.C. § 1101 et seq. (1970).

A. Radical Change is Unnecessary

While it is true that property and casualty insurance companies have suffered losses in recent years, there is no evidence that the radical regulatory surgery contemplated by the Act is either needed or that it is in the public interest. In fact, statistics indicate that the financial posture of the industry has experienced substantial improvement in recent months. Notwithstanding these encouraging signs, it is clear that some state regulatory procedures could be improved. This is not an unusual situation for state or Federal regulatory structures. IIAA supports appropriate changes where they are needed. However, it has to be recognized as a fact that the insurance regulatory structure currently in existence in the various states has been adequate to weather a period of financial strain on the property and casualty industry without a major failure of a property and casualty insurance underwriter. Improvements can and are being made at the state level. Far from aiding in those efforts, the Act has the potential of frustrating them entirely.

B. Formation of Another Federal Bureaucracy Should Be Avoided

The Act contemplates the establishment of yet another potentially vast Federal bureaucracy at just the time when there is virtually universal recognition that the size and involvement of the Federal government in the affairs of society should be significantly reduced. History has taught us that bureaucracies seldom get smaller or go away, irrespective of the continuation of any problem they were established to solve. For this reason,

the Congress should be very reluctant to establish yet another Federal agency which will further the process of accretion of power to the Federal government, while, as a practical matter, making meaningful insurance regulation at the state level a thing of the past.

C. Depletion of State Insolvency Funds

The Act would likely exacerbate any regulatory problems which might exist at the state level. Because of the nationwide character of their operations, there may be an appeal (either superficial or otherwise) for some large insurance underwriters to opt for Federal regulation. Under Section 103 of the Act, such companies would not have to make contributions to state insolvency funds. Accordingly, state insolvency plans would lose significant sources of contributions at precisely the time it is alleged that the viability of such plans is being threatened. The state insolvency funds available to cover any claims would be diminished. In this way, policy holders and claimants of insurance companies which remain State-chartered and which do not opt for Federal-guarantee status could suffer financial loss which would not have occurred but for the depletion of the state insolvency funds. Furthermore, the highly unsalutary effect of the insolvency would be intensified by the concentration of its impact in a relatively small economic area.

**D. State Regulated Underwriters
Could Be Compromised**

If significant numbers of underwriters were to choose the option of being Federally-chartered as provided by the Act, the viability of companies choosing to remain state regulated could be undermined. This possibility would be greatest if the large nationwide insurance underwriters in great numbers were to choose Federal regulation. There might be created in the minds of the public the impression that they would somehow be better off if they purchase their insurance from a Federally-chartered insurance company. Perfectly stable and solvent intrastate insurance underwriters might then begin to lose business to the nationwide companies for reasons having no real economic basis. Smaller intrastate underwriters which had previously never experienced financial difficulties could find themselves unable to compete effectively with the large Federally-chartered nationwide organizations. This, in turn, would bring about a reduction of competition within the property and casualty insurance underwriting business, which would be seriously at odds with the public interest.

E. Cross-Subsidization

The pricing of insurance policies is performed by the insurance underwriter based on the underwriter's assessment of losses, administrative expenses and taxes associated with a particular policy. The risk associated with various coverages and the cost of losses when they are incurred vary with different

locations in the country. Under Section 201 of the Act, Federally-chartered insurers would become exempt from state regulation. Such exemption would provide Federally-chartered insurers, particularly those which are large nationwide underwriters, greater flexibility in cross-subsidizing the rates charged for various coverages in one area with the profits derived from premiums charged on the same coverages in different areas. In this way, such entities would have an unfair competitive advantage over smaller, more local insurers which elect to remain State-chartered and thereby state regulated.

F. Maintenance Costs

Experience has shown that the cost of the maintenance of a Federal bureaucracy is substantial. Furthermore, it increases over time -- it never diminishes. The costs associated with the two-tier regulatory system contemplated by the Act would be significant indeed. Furthermore, they would end up getting passed along to the insurance consumers in the form of higher insurance prices.

G. Flexibility of Current System

It is well recognized in the insurance industry that conditions and problems differ substantially from state to state. For example, while markets for certain lines of insurance may be very tight in a number of states, companies

may be actively seeking new business in those same lines in other states where those lines are more profitable. State insurance regulators are better able to react to the particular needs of the industry in their states than would the Federal regulatory body contemplated by the Act. The particularized regulatory attention currently provided at the state level would be impossible under any scheme of Federal regulation where one regulatory policy and one set of rules would apply to all the states. Furthermore, the state insurance departments, which would certainly have their roles reduced if the Act were enacted, are much closer and more responsive to the insurance consumer than any Federal regulator could possibly be. The flexibility and responsiveness of the state insurance departments are significant benefits afforded by the current regulatory scheme. As such, they should be perpetuated, not undermined.

H. Regulatory Conflicts

From a strictly regulatory point of view, the dual regulatory scheme contemplated by the Act creates numerous potential problems; specifically, (i) differences in Federal/State regulatory policy; (ii) differences in specific Federal/State regulations which address the same situations; (iii) tendencies of regulated entities to shop for the most lenient

regulator;^{4/} and (iv) disputes between Federal/State regulators over which has jurisdiction in particular situations.^{5/}

IV. Legislative Alternatives Congress Should Consider

IIAA believes that the current regulation of the property and casualty insurance industry by the various states is adequate to protect the public interest. While there certainly exist ways in which the regulation of the property and casualty insurance industry could be improved, we believe that the radical regulatory restructuring contemplated by the Act is out of proportion with the problems that may currently exist. Furthermore, the regulatory scheme contemplated by the Act could seriously disrupt the property and casualty insurance industry at a time when it is recovering from the adverse effects of the recent period of high inflation and low economic growth.

4/ In the context of multiple bank regulation at the Federal level, Chairman Arthur Burns of the Federal Reserve Board stated that the difficulties recently experienced by major banking institutions were in part due to the "competition in laxity" among the various bank regulators. Address by Arthur F. Burns, Chairman, Board of Governors of the Federal Reserve System, 1974 American Bankers Association Convention, at 18 (Oct. 21, 1974).

5/ Such disputes would be especially likely under the Act in that there would be State-chartered insurers which are Federally-guaranteed.

Much of what is contemplated by the Act has been considered by Congress before. In the 91st Congress, legislation entitled The Federal Insurance Guaranty Agency Act (S. 2236) was introduced. Such legislation would have expanded the authority of the Federal Insurance Administration under the Department of Housing and Urban Development and would have permitted the payment of contractual obligations of policies guaranteed under that act when an insurance underwriter became insolvent. It should be noted that S. 2236 was not enacted even though it was far less ambitious than the Act and was considered in an environment where, in the twelve years immediately preceding consideration of the legislation, 143 property and casualty insurance companies had allegedly become insolvent.^{6/}

In 1970, in response to S. 2236, the Administration introduced S. 3542 entitled the Federal Insurance Guaranty Act. The purpose of that act was to provide a national program within the framework of state regulation of the insurance industry, for the expeditious compensation of consumers for losses incurred when property and casualty insurance underwriters were to become insolvent and funds available at the state level were insufficient to satisfy valid claims. That legislation

^{6/} See S. Rept. No. 1433, 91st Cong., 1st Sess. 6 (1970).

left the primary responsibility to the satisfaction of claims arising out of the insolvency of an insurer to the state regulatory authorities in the jurisdiction in which the insolvency occurred. Only in the event that state insolvency funds were inadequate would claims have been permitted to be made to the Federal Insurance Administrator. Again, even though S. 3542 was a more moderate solution to the insolvency problem than was embodied in S. 2236, it was not enacted.

Yet another possible alternative to the Act would be the establishment of a Federal fund which could contribute toward the payment of claims arising out of insolvency of insurance underwriters if there existed in the state where the insolvency occurred a regulatory program which provided (a) that the state pay at least 25 percent or some other percentage of any claim, (b) that the state guarantee that funds provided to the state insolvency plan by contributions not be available for use for other purposes, and (c) that insurance company contributions to the state insolvency plan would be set at a given minimum level.

We do not endorse any of the foregoing alternatives, since we believe that whatever ills may currently exist at the state level can be effectively cured at the state level. We allude to these alternatives to emphasize that there are numerous solutions to the problems addressed by the Act which are not only less extreme than the Act, but also more relevant

to the current problems of the property and casualty insurance industry. The alternatives we have listed, and others that might be thought of, should be considered carefully by Congress before any remedial legislation is ultimately enacted.^{7/}

V. Conclusion

The Act contemplates a radical restructuring of the regulatory scheme effecting the property and casualty insurance industry. Such restructuring will inevitably have a significant impact on the competitive forces within that industry. As such, the Act has the potential of causing serious dislocation in the marketing structure of an industry which for many years has worked effectively. The result for the public is likely to be fewer insurance companies, a more highly concentrated industry, and less competition. In addition, insurance agents will have fewer competing sources from which to obtain insurance and there will be presented a weakened system of state insolvency funds and a higher price tag for insurance regulation.

For these reasons, IIAA believes that the Act is much too ambitious to address the current problems existing in the industry. The state regulatory structure is currently in

^{7/} In the context of the Act, in light of the number of insurance agents throughout the country and their importance in the marketing processes of the industry, the Act in Section 101 should be amended specifically to provide that the advisory committee to the Federal Insurance Commission be required to include one or more insurance agency representatives.

place and has recently weathered some difficult economic times. For this reason, that structure should be maintained and improved, not undermined.

Accordingly, IIAA opposes the legislation and strenuously urges that solutions to the current problems be sought in the first instance at the state level. Only if those problems cannot be solved there would it be appropriate to consider action at the Federal level, and even then that action should be far less ambitious than is contemplated by the Act.

Thank you for providing us this opportunity to express the views of the Independent Insurance Agents of America.

The CHAIRMAN. Thank you very much, Mr. Kremer.
Mr. Douds.

**STATEMENT OF H. JAMES DOUDS, GENERAL COUNSEL, THE
NATIONAL ASSOCIATION OF UNDERWRITERS**

Mr. Douds. Thank you, Mr. Chairman, NALU is made up of 135,000 life insurance agents doing business in this country.

I think it might be of interest to this committee to know that these members of NALU represent 971 of the life insurance companies in America that would be directly affected by S. 1710.

Overall, I should say that, as an overall comment on the bill, we look upon this as an attempt at the Federal level to solve what we consider to be a State problem. But we do appreciate the opportunity to be heard and we want to be as constructive and helpful as we can, given the circumstances.

Therefore we would like to enumerate some of the objections we have to the bill for whatever value this might have when the bill is further considered, so that there might be some possibility that support from organizations such as ours might be garnered in the future.

We are just saying we do not believe in its present terms that S. 1710 is adequately designed to meet the problem.

First, the argument we have already alluded to, and that is that insurance as an industry, and one of the last, we might say, which has heretofore, indeed with the blessing of the Congress, been regulated at the State level. It is a major industry, Mr. Chairman, and as you said on Monday, it has in fact done a good job. And we would add, that it has done this good job under State regulation, and therefore we would think if guarantees against insolvency are to be provided, they should be provided at the hand of the State governments, and not the Federal Government.

As Senator Brooke himself said in introducing the bill, the financial solvency picture had improved significantly from the time of the GEICO crisis of a year before. I don't think we should fail to keep in mind that the GEICO crisis was averted, not by any Federal device or mechanism, but that crisis was averted by the ingenuity of the very State regulation that S. 1710 would seek to supplant.

Senator BROOKE. If you would yield there, there is some dispute about that. The private companies actually were the ones, I think, that averted the crisis for GEICO. But I certainly don't want to take anything away from the State regulators in their assistance in that. I quite agree it was not done with any Federal assistance.

Mr. Douds. I was referring to Superintendent of Insurance Wallach of the District of Columbia, who acted as a quarterback, as it were, in trying to rehabilitate the company.

Second, and more important from the NALU point of view, we understand that nothing in S. 1710 is intended to affect the general qualifications of licensing and day-to-day activities of insurance agents.

But at the same time, section 101(b)(7) of the bill would give the Federal Insurance Commission the power to examine and require reports and records of federally guaranteed insurers or applicants for

such status, or their "managers and agents," and I am quoting from the bill.

In the lexicon of the life insurance business, managers and agents are the very field people we represent, whereas in a more legal sense of the term, it might refer to corporate representatives generally. Perhaps it would be appropriate to include clarifying language, maybe in the definitions section of the bill, if in fact the bill is not intended to directly affect the day-to-day activities of insurance agents.

I think a similar clarification would be in order in section 108, which gives the Commission supervisory authority over "agents."

Third, and even more disturbing to us, is the power the Commission would have to promulgate regulations such as it might deem necessary to carry out the purposes of the act.

This is a power which we would almost be willing to bet would be the subject of bitter dispute as time went on. Because under the dual regulatory system that the bill is designed to set up, the Federal Insurance Commission really couldn't do its job properly, unless it stepped into the territory of many areas of State regulation. This would be true not only with respect to federally chartered insurers, but it would be true with respect to federally guaranteed insurers, and with respect to applicants for one or the other status as well.

As Mr. Hunter so well said the other day, it does seem to us with this new Federal regulatory power, insurance regulation stands a good chance of being sliced into 100 rather than 50 pieces.

Fourth, the bill gives the Commission the power to allow insurance companies to get into businesses that are complementary or incidental to insurance. No one knows better than the members of your committee, Mr. Chairman, the trouble that can be caused by legislative language that is as broad and vague as this.

We have only to look at the Bank Holding Company Act amendments of 1970, and the disputes and the problems that have been caused by them in trying to decide what is closely related to banking and what is an incident to banking and what is not.

If I might, I would like to submit for the record an excerpt from an article in *Economic Perspective*, a publication of the Federal Reserve Board, which chronicles 39 nonbanking activities that have either been approved by the Fed, are pending, or have been disapproved.

The CHAIRMAN. We are glad to have that for the record. It will be printed in full.

[The information follows:]

"INCIDENTAL" ACTIVITIES OF BANK HOLDING COMPANIES

The March-April 1977 issue of *Economic Perspective*, a publication of the Federal Reserve Board, reviews the nonbanking activities of bank holding companies which have been approved by the Board; those that have been denied, and those that are pending. The list is a good chronicle of 39 nonbanking activities which banks feel are "incidental", some of which insurance companies might well also consider to be such if S. 1710 were to be enacted:

ACTIVITIES PENDING BEFORE THE BOARD

1. Armored car services.¹
2. Underwriting mortgage guarantee insurance.¹

¹ Added to list since January 1, 1975.

3. Underwriting and dealing in U.S. Government and certain municipal securities.^{1,2}

4. Underwriting the deductible part of bankers blanket bond insurance (withdrawn).¹

5. Management, consulting to nonaffiliated, depository type, financial institutions.^{1,2}

ACTIVITIES APPROVED BY THE BOARD

1. Dealer in bankers' acceptances.¹
2. Mortgage banking.²
3. Finance companies.²
 - a. consumer.
 - b. sales.
 - c. commercial.
4. Credit car issuance.²
5. Factoring company.²
6. Industrial banking.
7. Servicing loans.¹
8. Trust company.¹
9. Investment advising.²
10. General economic information.²
11. Portfolio investment advice.²
12. Full payout leasing.²
 - a. personal property.
 - b. real property.
13. Community welfare investments.¹
14. Bookkeeping and data processing services.²
15. Insurance agent or broker—credit extensions.²
1. Equity funding (combined) sale of mutual funds and insurance.
17. Courier service.²
18. Management consulting to nonaffiliate banks.²
19. Issuance of travelers checks.¹
20. Bullion broker.²
21. Land escrow services.^{1,2}
22. Issuing money orders and variable denominated payment instruments.^{1,2,3}

ACTIVITIES DENIED BY THE BOARD

1. Equity funding (combined) sale of mutual funds and insurance.
2. Underwriting general life insurance.
3. Real estate brokerage.²
4. Land development.
5. Real estate syndication.
6. General management consulting.
7. Property management.
8. Nonfull-payout leasing.¹
9. Commodity trading.¹
10. Issuance and sale of short-term debt obligations ("thrift notes").¹
11. Travel agency.^{1,2}
12. Savings and loan associations.¹

Mr. Douds. It is a good chronicle of the kind of activities that insurance companies, given the same entrepreneurial latitude, would be just as innovative as the banks have been in getting into businesses perhaps where they have no business being.

So we would say with respect to this bill, as we did in 1970 when the Bank Holding Company Act amendments were pending, if this is to be a power of insurance companies, there ought to be a so-called laundry list in the bill, spelling out what it is they can get into and what

¹ Added to list since January 1, 1975.

² Activities permissible to national banks.

³ These were found to be "closely related to banking" but the proposed acquisitions were denied by the Board of Governors as part of its "go slow" policy.

⁴ To be decided on a case-by-case basis.

they cannot get into, to prevent the kind of trouble we have had with the banks.

Fifth, we would say the concept of a guaranty fund is laudable, but as you have heard many times, it would be set up in direct competition with State funds, and competition for laxity, or what has more salaciously been called a "perverse competition" would be generated.

The Federal Government might initially, by attractive devices, seek to lure insurers into it's fund. This could be very damaging to the State funds.

Another section would deal an even more powerful blow to State regulation and that is the section that says that once the Federal charter is issued, the insurance company can do business in any State.

It is very difficult to conjure up any more serious usurpation of State regulatory power than that one, considering that licensing of companies is a mainstay of State regulation.

Our sixth point of concern is with the tax section of the bill. It is a very hard section to understand. But as we do understand it, the State of Wyoming, for example, could not tax a federally chartered insurance company from Maine any more than the least taxed foreign company is taxed in any State. That is what the language seems to say. If that is the case, it would seem the bill would ask Wyoming to adopt as a standard the lowest tax of any State in the Nation.

In any event, we would urge clarification of that language. And we would say this: unless some argument can be advanced to support a thesis that State premium taxes have somehow been the cause of insolvency, we wonder why this is in the bill. We would have thought the ability to pay taxes to be a sign of solvency, not insolvency.

Finally, with respect to Federal charters in general, these charters have always had about them an aura of the prestige of the United States. We would wonder whether the Congress would be willing to authorize their issuance on a wholesale basis to the 1,800 or so life insurance companies in America, many of whom may want the charter to avoid burdensome or onerous State taxation, many of whom might want the charter to get into other States, where they have not before been allowed to do business.

As we indicated earlier, in conclusion, we endorse the major goal of S. 1710, which is to guard against insurance company insolvencies, but we do have certain reservations about it.

We appreciate Senator Brooke's remarks that proposals like this take many years sometimes to gain acceptance, and we hope that with the passage of time, as State regulation is improved, maybe enactment of S. 1710 might even be rendered unnecessary.

Thank you.

[The complete statement of Mr. Douds follows:]

Statement of
The National Association of Life Underwriters

Mr. Chairman, members of the Committee, my name is H. James Douds, and I am General Counsel of The National Association of Life Underwriters, which is now made up of 132,000 life and health insurance agents, general agents and managers doing business in virtually all of the communities in all of the fifty states of the Country. The members of NALU would naturally be individually affected by the enactment of a measure like S. 1710, but I think it will interest you to know that these life and health insurance field people represent 971 of the presently state-regulated life insurance companies that would be even more directly affected by the bill.

As we understand it, S. 1710 would provide a federal chartering alternative for insurance companies and establish a Federal Insurance Guaranty Fund to protect insurance company policyholders. Insurers, whether or not federally chartered, would be eligible to participate in the guaranty fund, and federally chartered insurers would be required to participate. Insurers, under the bill, could elect to become federally chartered, in which case they would obtain certain immunities from state insurance regulation and taxation; or they could opt to continue under the present system of state regulation, and, even so, they

could still become federally guaranteed (although not federally chartered) by meeting the financial and other requirements prescribed by a Federal Insurance Commission which is also to be created by the enactment of S. 1710.

S. 1710, as we understand from Senator Brooke's remarks when the bill was introduced earlier this year is a refinement of S. 3884, which was in turn introduced "as a working document" as the 94th Congress adjourned. Neither bill, we take it, is to be taken as definitive, as the Senator has stated that "No doubt this legislation will be further modified as comments are received on the version of the bill [S. 1710] which I introduce today."

We are grateful that S. 1710 is not to be considered as being in final form, because, as it now stands, the bill contains certain provisions and carries other clear inferences which make it impossible for us to support it. As an overall observation, we look upon S. 1710 as a federal attempt to solve what we regard as a state problem, and thus we seriously doubt whether S. 1710 can be amended in such a way as to enable us to endorse it.

At the same time, however, we appreciate the opportunity to appear before your Committee in the matter, and we do want to be as constructive and helpful as possible under the circumstances. Therefore, we would like to enumerate some of the criticism we have of S. 1710, for whatever value this might have in determining whether S. 1710 can be appropriately amended so as to garner the

support of some of us who, sympathetic as we are with Senator Brooke's concern over the consequences of insurance company insolvencies, do not feel that federal chartering of insurance companies in the manner proposed by the bill is the way to meet the problem.

First, the argument we have already alluded to: insurance is an industry--and one of the last, we might say--which has heretofore, with the blessing of the Congress, managed to elude federal regulation. If guarantees against the insolvencies of insurance companies are needed, they should be awarded under the hand of the states, not the federal government. There is ample evidence that substantial progress is being made toward this end, in that, as the testimony of the National Association of Insurance Commissioners has so clearly shown, the number of operative state guaranty funds is impressive and growing. At the same time, as Senator Brooke himself said in introducing S. 1710 in June, the outlook from a financial solvency viewpoint has improved since the dark days of a potential GEICO insolvency a year before. (It must be remembered, too, that while the idea for the original federal chartering proposal grew out of concern in the GEICO matter, that same potential financial disaster was averted, not by any federal action or device, but by the ingenuity of the very state regulation that S. 1710 seeks in so many ways to supplant).

Second, and more pertinent from the MALU point of view, we understand that nothing in S. 1710 is intended to affect the

qualification, licensing or general activities of insurance agents. State regulation of these facets of the business is to be left in place. If so, certain aspects of the bill should be made clear in this regard. For example, Section 101(b)(7) would give the Federal Insurance Commission the power "to require information and reports from all federally guaranteed insurers or applicants for a guaranty or charter, their managers and agents" (emphasis added). "Managers and agents", in the lexicon of the insurance business, are actually the field sales people NALU represents, whereas in the more usual legal usage the terms refer to corporate representatives generally. Perhaps the inclusion of clarifying language in the Definitions section of the bill would be appropriate to clarify this point, if in fact field sales people are not to be generally affected by the bill. Similar clarification should also be made in Section 108 of the bill, which gives the Commission supervisory authority over the "agents" of federally guaranteed insurers. If agents are indeed to be broadly affected by S. 1710, then we would also oppose the bill on that ground.

Thirdly, and even more disturbing, is the section of the bill--Section 101(b)(10)--giving the Commission the power to prescribe "such rules and regulations as it may deem necessary to carry out the provisions of this Act." This is a power which, in our opinion, would almost as a guaranteed certainty be the subject of bitter dispute as time went on. We say this because, on the

one hand, S. 1710 is supposed to set up a cooperative dual regulatory venture between state and federal governments under which large parts of the industry are to be left unaffected under the new scheme of things; yet at the same time the Federal Insurance Commission is to be charged with doing all that it can to assess the solvency and managerial quality of insurers, to prevent insolvencies, and to rehabilitate ailing insurers. In trying to do this, the Commission really could not do its job properly unless it were to infringe on almost all of the territory now within the regulatory domain of the states, certainly with respect not only to federally chartered insurers, but federally guaranteed insurers as well, not to mention applicant-insurers for one or the other category. Once again, this regulatory power is one which would have to be circumscribed very, very carefully, and one could seriously question whether such a legislative drafting job could be satisfactorily accomplished.

Fourth, Section 202(a)(8)--page 53--of the bill provides that, with the approval of the Federal Insurance Commission, federally chartered insurers shall have the power "to conduct any other business which is complementary or incidental to the insurance business or the functions performed therein."

No one knows better than the members of your Committee, Mr. Chairman, the unfortunate consequences that can flow from this kind of broadly permissive legislative language: misunderstanding, misinterpretation, overreaching, and litigation, to name just some.

We have only to recall the trouble that has been caused by the permission given to bank holding companies by Section 4(c)(8) of the Bank Holding Company Act of 1956, as amended in 1970, for them to enter into businesses so closely related to banking or managing or controlling banks "as to be a proper incident thereto". Endless arguments might be --indeed have been--advanced why banks should not have entered many of the other businesses they are now in by virtue of this language. Be that as it may. The point is that if insurance companies are to be permitted the same entrepreneurial latitude, they will no doubt be at least as innovative as the banks have been in discovering, as "incidental", hitherto alien businesses (maybe even banking!) to be "complementary" or "incidental" to insurance. What we are suggesting here, as we did when the 1970 amendments to the Bank Holding Company Act were pending before your Committee, is that, if insurance companies are to be permitted to engage in other businesses, the bill should be amended to include a so-called "laundry list" of permissible activities to prevent the problems which have arisen in connection with the Bank Holding Company Amendments. [For an elaborate discussion of the problems stemming from the kind of permissive general legislative language in question, see Alabama Ass'n of Ins. Agents v. FED, 533 F. 2d 224.]

Fifth, we see clear inroads into state regulation and state prerogatives in Section 103(k)--page 23 of the bill--

and in Section 201(b)(2)--on page 47. The first section would undercut existing and contemplated state insolvency plans by exempting federally guaranteed insurers from participation in them. The concept of a federal guaranty fund is laudable enough, but to the extent that this would set up direct competition with similar state funds, a competition for laxity, or what has been called a "perverse competition" could result, as the states and the federal government might seek, by initially attractive devices, to lure insurers into one or the other system. Certainly to the extent that insurers might be enticed away from existing state funds, those state funds would suffer perhaps terminal damage.

The other section--Section 201(b)(2)--would deal an even more powerful body blow to state regulation of insurance, providing as it does that once a federal charter has been issued to an insurer, any state license the insurer may have would be preempted and "the insurer shall be deemed to be authorized to do business in any state" (Emphasis added, for it is difficult to conjure up a more violent federal usurpation of state insurance regulatory authority than this.) Furthermore, one would wonder what this provision has to do with protecting policyholders against insurance company insolvencies.

Our sixth point of concern is with the tax section of the bill, Section 204(b)--on page 56. Although this section is couched in some of the more labyrinthian legislative language

we have seen, we understand it to mean the following: under the present system, let us suppose Wyoming taxes foreign companies 3% but Wyoming law also says that if any state taxes Wyoming companies more than 3%, then Wyoming will tax the companies of that state the same amount--4%, let's say. This is the retaliatory tax law. Under it, therefore, if Maine taxes foreign companies 4%, then Maine companies will have to pay a 4% instead of a 3% tax in Wyoming. S. 1710 would apparently change this by saying that Wyoming could not tax a Maine company any more than it would tax the least taxed foreign company, regardless of the state that company comes from. Thus, S. 1710 would seem to result in the federal government telling Wyoming that, as far as out-of-state companies are concerned, Wyoming must settle for the lowest tax rate in the nation. [This conclusion seems inescapable in view of the use of the word "any" in lines 17 and 21 on page 56 of the bill.]

Unless a cogent argument can be made to support the proposition that state premium taxes have somehow caused insurance company insolvencies, we would wonder why this federal interference with state taxation of insurance companies needs to be included in S. 1710. We would have thought that the ability to pay taxes was a sign of solvency, not insolvency.

Seventh, and finally, with respect to federal charters in general, we would remind the Committee that such charters have had about them an aura of the prestige of the United States, and

that the Congress might well be loath to authorize their issuance on a wholesale basis to insurance companies just because they meet certain financial requirements, particularly when it may appear that one of the motives of some companies in seeking the imprimatur of a federal charter might be to gain an entree into states theretofore closed to them or to escape certain taxation and regulation they might consider to be onerous.

Section 201(b)(2) of the bill provides that upon the issuance of the federal charter the state charter or other authority of organization of the insurer shall be preempted and terminated. The criteria which the insurer must meet under S. 1710 to obtain the federal charter are primarily financial and managerial, and no insurer meeting these criteria, profit or nonprofit--except one issuing assessment insurance--would be precluded from obtaining a federal charter.

If there is to be a system of federal chartering, then it should be essentially open to all, but there may be a conflict in the making here, between the Federal Insurance Commission issuing federal charters on an even-handed basis to all insurers meeting the criteria laid down by the Commission, and the intent of Congress concerning proper subjects for the issuance of federal charters. The potential conflict occurs because many insurers, otherwise qualified under S. 1710 for federal charters, are non-profit organizations--the 90 or more member societies of the

National Fraternal Congress of America, for example. These societies operate on a legal reserve basis and make an undisputedly valuable contribution not only to the social welfare but also to the economic security of the Country. Under S. 1710, the Commission would--and should--recognize non-profit insurers as being entitled to federal charters; yet these same insurers would no doubt be refused a federal charter were they to make direct application to the Congress therefor. See Joint Agreement of Senate Subcommittee on Federal Charters, Holidays and Celebrations and Subcommittee No. 4, House Committee on the Judiciary, 91st Cong., 1st Sess., Standards for the Granting of Federal Charters to Nonprofit Corporations (Comm. Print 1969), wherein one Standard adopted to determine if a charter should be issued is whether the petitioning organization is "of such unique character that chartering by the Congress as a Federal corporation is the only appropriate form of incorporation", and another is whether the organization is to be operated to meet a need which "cannot be met except upon the issuance of a Federal charter".

Thus, in issuing federal charters to qualified nonprofit insurers, as it would be called upon to do by the terms of S. 1710, the Federal Insurance Commission would always seem to be in contravention of the Standards adopted on behalf of the Congress in the joint agreement quoted above because, quite obviously, no insurance company, profit or nonprofit, could satisfy these standards.

As indicated earlier, Mr. Chairman, we completely

endorse the major goal of the proponents of S. 1710, which is to protect policyholders against the great losses they stand to suffer from insurance company insolvencies. As you have seen, however, we do have certain reservations about the proposal, more of them having to do with Title II (federal chartering) than with Title I (the guaranty program). Perhaps the proposal would be more acceptable if the federal chartering Title were to be taken out of the bill.

In any case, we are grateful for the opportunity to present our views, and while we regret that we cannot endorse S. 1710, we appreciate Senator Brooke's remarks in the September 6 issue of the Washington Insurance Newsletter to the effect that proposals such as this often take several years to gain acceptance and that he is always willing to consider proposed changes to the bill. We hope that some of the points in our statement will be helpful as S. 1710 is given additional in-depth consideration. We trust--and we feel sure the Senator would share this sentiment --that the further passage of time might see such additional significant progress at the state level that adoption of a federal program might even be rendered unnecessary.

* * *

The CHAIRMAN. Thank you, Mr. Douda.
Mr. Hiestand.

**STATEMENT OF JEAN C. HIESTAND, VICE PRESIDENT COUNSEL, ON
BEHALF OF STATE FARM INSURANCE CO. OF BLOOMINGTON, ILL.**

Mr. HIESTAND. Thank you, Mr. Chairman. I am Jean C. Hiestand. Our General Counsel, Donald P. McHugh, was to present this statement, but he had an unfortunate accident on the weekend and he asked me to express his appreciation for the opportunity to appear here and his regret at being unable to present the statement.

These hearings and the report of the Department of Justice have focused attention on two of the most fundamental issues involving the insurance industry, competition and solvency.

Particularly in the area of competition, we are hopeful this examination will lay the groundwork for prompt legislative reform.

These hearings can provide a most constructive impetus for expanded and more effective regulatory action in the solvency area.

In our presentation here, we will address both of these important issues. First, we strongly support the precept of S. 1710 that competition is the most efficient arbiter of insurance prices. We endorse the Department of Justice conclusion that State rate regulation has not served the public interest. For many years, we have been urging that the McCarran Act be amended so as to apply the Federal antitrust laws to ratemaking activities in personal lines of insurance, although we would achieve these results in a fashion different from S. 1710, avoiding the need for any Federal regulatory superstructure.

Second, in the area of solvency, we are not yet convinced that State regulation is unequal to the task, if the States undertake a more efficient, intensive, and innovative program of solvency regulation. Most particularly, if regulators are freed from the unnecessary, burdensome, and sometimes counterproductive responsibilities in the area of rate regulation, they can focus major attention on the essential end of State regulation—protecting the public from the consequences of insolvencies. Only if accelerated attention at the State level proves insufficient should the Federal Government displace the States in the area of solvency regulation.

State Farm believes the time has come to deregulate the pricing of personal lines of insurance. Rate regulation is preventing insurance companies from adequately responding to fast changing conditions. The rigidity inherent in administrative regulation of rates has not only created the problems known to all insurers as "the regulatory lag," but has also deterred innovation in and experimentation with different forms of rating techniques. Unnecessary regulation has led to market constrictions in some States and, in certain instances, to severe financial stress on companies. More particularly, political interference with the State rate regulatory process is severely disrupting the ability of insurers to manage their businesses in accordance with the legitimate needs of the marketplace.

We agree with the thoughtful studies which have repeatedly concluded that rigorous price competition—not rate regulation—most effectively and efficiently promotes the public interest.

We amplify the following points in the ensuing section of our statement. First, structural conditions are appropriate for competition. Second, rate regulation has sanctioned cartel pricing. Third, rate regulation is not needed to prevent ruinous price cutting. Fourth, rate regulation is not needed to prevent excessive rates. Fifth, rigid rate regulation has frequently worked against the consumer and restricts insurance markets. Sixth, State experience shows that competition works.

We then present our proposal to amend the McCarran Act to deregulate and apply the Federal antitrust laws to the pricing of automobile insurance. We first proposed this program 10 years ago. We presented it to the Antitrust Monopoly Subcommittee in 1969 and we present it again today.

The essential provisions are as follows:

1. The McCarran Act should be amended so as to deregulate insurance pricing—rates, rating plans, rating territories, rating classifications, and policyholder dividends—for the personal lines of property and casualty insurance, including automobile insurance and homeowners insurance, and for very limited, related commercial lines. Deregulation would be accomplished by necessary preemption of State rating laws. Our amendment to the McCarran Act would leave intact the authority for States to regulate comprehensively the business of insurance in almost all respects, including regulation relating to solvency, licensing of companies and agents, the insurance contract, complaints, and unfair trade practices.

2. Although the Federal antitrust laws would be made to apply to rating activities for these property and casualty lines, we would exempt joint collection of loss statistics and joint collection of data relevant to the identification, prevention or reduction of losses.

3. The amendment would contain a qualification which permits State regulation and private joint action in the establishment and operation of residual market plans for these lines, with attendant antitrust immunity. Residual market plans would be prohibited from charging rates which could adversely affect the voluntary market.

4. To assist in developing shopper's guides and otherwise marking rating information readily available to consumers, States would be authorized to require the filing of insurance price information on these coverages after insurance rates have been placed into effect.

This approach is somewhat different from the approach suggested by S. 1710, and the Justice Department report. The major differences are:

1. Our plan would have mandatory application to all insurance companies writing covered lines of insurance. We believe that the public cannot get the full benefit of price competition if companies have the choice of either vigorously competing under the antitrust laws or remaining under State rate regulation.

2. Only personal lines of property and casualty insurance (and certain very closely related commercial lines) would now be covered by our proposal.

3. Certain limited joint activities in the gathering of statistics should be specifically allowed.

4. Our proposal deals only with insurance pricing. It would be implemented without involvement of any Federal agencies, other than those agencies which enforce the antitrust laws.

With regard to competition and insurer solvency, we believe rate regulation is not essential to solvency and withdrawal of weak companies in a competitive system need not harm the public.

We have carefully considered the proposals of S. 1710 to establish a Federal mechanism for reimbursement of consumer losses from insurer insolvency, the regulatory and supervisory authority in connection therewith, and, to a lesser extent, the prevention of insolvencies. It is our present judgment that these problems, and the mechanisms to solve them, can be handled at the State level—but only if the States undertake expanded and accelerated efforts in this area. There are tools at hand for States to improve their record. There is a heavy burden of proof on those who would displace State regulation for solvency. We have as yet seen no convincing evidence that would satisfy that burden.

We believe that if insurance departments are freed from their responsibilities in the rate regulatory area, they can direct greater efforts to preventing insolvencies and diminishing the public impact of companies which leave the marketplace. They will be better able to identify a troubled company before it becomes insolvent and either assist it in correcting its problems or help it withdraw from the market through merger, reinsurance or orderly liquidation.

We do share Senator Brooke's concern about the potential domino effect of a large insolvency. We think the fact that 16 States have enacted access to assets legislation, mentioned by previous witnesses is significant—and we support that legislation and we would hope it would be enacted in all important States thereby alleviating the possibility of a very serious domino effect should a large insolvency occur.

Further, we have presented to the committee, as we presented to the Antitrust Monopoly Subcommittee in 1969, our policyholder security account proposal, a proposal which would give to the insurance commissioner the early warning which he should have, a concept recognized in this bill, and it would assist him in preserving good assets of insurance companies so as to reduce the possibility that insolvencies might occur and to assure that whatever insolvencies might occur would have a minimum impact.

Therefore, in summary, we believe that the Congress should move to deregulate insurance pricing. The need and the public benefits are clear. As to the solvency issue, we believe there is not yet a clear demonstration of need to alter the present reliance on State regulatory officials. If States no longer need to direct their attention to rate regulation, they will be able to be more vigilant and creative in their efforts to prevent insolvencies or to reduce their impact.

Insurance rate regulation and insolvency, although related historically, are not so intertwined that they must be dealt with at the same level of government or by the same regulatory body. Only if under the new configuration, where competition is allowed to set rates, State regulators demonstrate that they are still unable to deal effectively with insolvencies, should Congress seriously consider adopting an approach to the solvency problem similar to the one suggested in S. 1710.

Thank you.

[Complete statement follows.]

STATEMENT ON BEHALF OF STATE FARM INSURANCE
COMPANIES OF BLOOMINGTON, ILLINOIS BY
DONALD P. MCHUGH, VICE PRESIDENT AND GENERAL COUNSEL
BEFORE THE U.S. SENATE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS SEPTEMBER 14, 1977

My name is Donald P. McHugh, Vice President and General Counsel of State Farm Insurance Companies. Accompanying me here today is Jean C. Hiestand, Vice President Counsel of State Farm Insurance. State Farm is the nation's largest automobile insurer, insuring more than 18 million automobiles. Also, as the largest writer of homeowners dwelling insurance, we insure more than 6 million homes. We appreciate this invitation to express our views on several critically important insurance issues raised by S. 1710.

1977 has been marked by two particularly important developments in the regulation of insurance. The first was the release in January of the landmark report by the United States Department of Justice entitled "The Pricing and Marketing of Insurance."^{1/} The second is the introduction of S. 1710 in June and

^{1/} "The Pricing and Marketing of Insurance," A Report of the U.S. Department of Justice to the Task Group on Antitrust Immunities, January, 1977.

the decision of this Committee to probe in public hearings the important questions raised by this bill.

These developments have focused attention on two of the most fundamental issues involving the insurance industry -- competition and solvency. Particularly in the area of competition, we are hopeful that this examination will lay the groundwork for prompt legislative reform. Likewise, these hearings can provide a most constructive impetus for expanded and more effective regulatory action in the solvency area.

In our presentation here, we will address both of these important issues. First, we strongly support the precept of S. 1710 that competition is the most efficient arbiter of insurance prices. We endorse the Department of Justice conclusion that state rate regulation has not served the public interest. For many years, we have been urging that the McCarran Act be amended so as to apply the federal antitrust laws to rate-making activities in personal lines of insurance, although we would achieve these results in a fashion different from S. 1710, avoiding the need for any federal regulatory super-structure.

Second, in the area of solvency, we are not yet convinced that state regulation is unequal to the task, if the states undertake a more efficient, intensive, and innovative program of solvency regulation. Most particularly, if regulators are freed from the unnecessary, burdensome, and sometimes counterproductive responsibilities in the area of rate regulation, they can focus major attention on the essential end of state regulation -- protecting the public from the consequences of insolvencies. Only if accelerated attention at the state level proves insufficient should the federal government displace the states in the area of solvency regulation.

I. COMPETITION

State Farm believes the time has come to deregulate the pricing of personal lines of insurance. Rate regulation is preventing insurance companies from adequately responding to fast changing conditions. The rigidity inherent in administrative regulation of rates has not only created the problems known to all insurers as "the regulatory lag," but has also deterred innovation in and experimentation with different forms of rating techniques. Unnecessary regulation has led

to market constrictions in some states and, in certain instances, to severe financial stress on companies. More particularly, political interference with the state rate regulatory process is severely disrupting the ability of insurers to manage their businesses in accordance with the legitimate needs of the marketplace.

We agree with the thoughtful studies which have repeatedly concluded that rigorous price competition -- not rate regulation -- most effectively and efficiently promotes the public interest. The conclusions of Department of Justice study in particular bear quoting at length:

"The Department observed that over the past ten years there have been a number of states that have adopted an 'open competition' system of rate regulation after attempting to administer a highly regulated system. The experimentation with competitive controls as a substitute for concerted ratemaking is evidence of the inadequacies of state rate regulation. Moreover, the emergence of independent pricing in segments of the property liability industry, despite restrictive state laws, may be attributed to an industry structure that favors competition, to certain inherent weaknesses in rate regulation, to the successful experimentation with deregulation in a number of states, and to the continuing Congressional investigation into insurance industry practices.

"In addition, the evidence compiled by the Department on the effects of rigid rate regulation in automobile insurance indicates that such regulation has fostered greater adherence to bureau rates, discouraged rate reductions, contributed to instability in insurance company operations, established various forms of cross-subsidization between good and bad drivers, imposed unnecessary restrictions on the collective merchandising and the direct writing of insurance, and aggravated the availability problem in which marginal or high risk drivers have difficulty obtaining coverage in the open market at the prevailing rates.

"On the other hand, the long-run experience of at least one major insurance state under an open competition system, in which the state has relied on market forces to control prices, suggests that unrestricted price competition can provide an effective substitute for rate regulation as a means of achieving reasonable prices and maximum efficiency in the sale and distribution of insurance. A comparison of the experience of the same insurers under certain open competition and prior approval systems suggests that competition fosters independent pricing, operating stability, and flexibility in the pricing structure. The relatively favorable performance of the insurance companies under the highly competitive system suggests that it provides a more effective mechanism for accomplishing the basic insurance goals of providing a reliable insurance mechanism and generally available

coverage at a price reasonably related to cost." ^{2/}

1. Structural Conditions Are Appropriate For Competition

Today, reliance upon the interplay of natural economic forces in a competitive market is, in our judgment, fully appropriate to insurance -- particularly with respect to personal lines of fire and casualty coverages such as automobile and homeowners insurance.^{3/} In these lines there are literally hundreds of companies vigorously competing for business, selling essentially similar products, with low levels of concentration relative to other industries, ease of entry, no significant economies of scale and no technological or other significant barriers to entering this business. Under traditional economic criteria, an industry with these characteristics would be highly competitive and would perform with high efficiency at reasonable price levels closely related to costs.

There is no valid reason, we believe, not to apply to these lines of insurance the same rules of

^{2/} Justice Department Report at pp. v-vii.

^{3/} See Joskow, "Cartels, Competition and Regulation in the Property-Liability Insurance Industry," The Bell Journal of Economics and Management, Autumn 1973.

our competitive economy that apply to other businesses.

2. Rate Regulation Has Sanctioned Cartel Pricing

Despite all the potential for vigorous price competition in this industry, historically the business had been dominated by price cartels. Although presently the power of price cartels has moderated, the prevailing pattern of state rate regulation today fosters price rigidity and deters innovation and independence.

Modern rate regulation stems from the 1944 Supreme Court decision in United States v. South-Eastern Underwriters Association,^{4/} holding that the antitrust laws apply to insurance. With the enactment of the McCarran-Ferguson Act a year later, the states had the opportunity to enact state regulatory laws to protect the public interest and foster needed competition. Unfortunately, the resulting state laws, as enacted or administered, have seriously impeded rigorous price competition in important insurance markets.

Most states adopted prior approval rating laws based on the model bill of the National Association

^{4/} 322 U.S. 533 (1944).

of Insurance Commissioners. Under these prior approval laws, rates prepared by private rate bureaus were submitted to the state insurance commissioner and deemed effective if not disapproved. Membership in the rate bureaus was voluntary and independent pricing was technically permitted if approval was obtained. But, in the early years of the prior approval laws, the delaying tactics of the bureaus and their opposition to independent filings and partial subscribership curtailed competitive pricing. Some states went even further and mandated membership in rate bureaus, required rate uniformity, and discouraged or prevented deviation.

This era was described in a 1961 report of the Senate Judiciary Committee:

"Violation of the antitrust laws was the predicate for the McCarran Act. Nevertheless, it is disturbing to note that more of the resources of State regulation in the ensuing years have been directed to curbing the forces of competition than to limiting the excesses of combinations. The record compiled by the subcommittee is an impressive recital of the many efforts during the years to curb competition, with much of it accomplished through utilization of State regulatory channels. On the other hand, the documents obtained by the subcommittee, which were made a part of the record, present a bleak picture of concerted efforts on a

nationwide basis to restrain competition which not only went unchallenged by the States but virtually unnoticed." 5/

State Farm as an independent filer of rates fought the dominance of this cartel system in the marketplace, in state legislatures, in regulatory proceedings and in testimony to the Congress over the years. We actively opposed restrictions in the rating laws inhibiting competition, and at a very early date vigorously supported so-called competitive rating laws -- laws which would place greater reliance upon competition. One state, California, passed such a law in 1947 and the states of Missouri and Idaho passed statutes which were not so restrictive as the so-called all industry prior approval laws. Unfortunately, however, at least forty-five states enacted either the all-industry prior approval statute or laws which were even more restrictive. The result was an industry in which price competition was discouraged and rate making by combination continued to be a way of life.

State Farm opposed the anticompetitive rate regulatory climate in which the industry operated during

5/ Senate Judiciary Report No. 831, 87th Congress, August 29, 1961.

the 20 years following the SEUA decision. We welcomed the movement toward state open competition rating laws, begun in the mid-60's and climaxed by a NAIC study recommending "fair and open competition to produce and maintain reasonable and competitive rates. . . ."^{6/}

But the picture today is not what it could be. The public has yet to receive the full benefits of competition throughout the country. Less than half the states have rating laws which rely on competitive pricing instead of government regulation; even these laws fall short of providing the full benefit of competition. Further reform at the state level seems to be at a virtual standstill. We believe that only through a federal initiative providing for deregulation of insurance will the people across the country receive the full benefits of vigorous competition.

3. Rate Regulation Is Not Needed to Prevent Ruinous Price Cutting

Historically, rate regulation in the property and casualty field first stemmed from a concern -- initially voiced in the Merritt Committee Report of

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^{6/} 1 Proceedings of the NAIC 310 (1969).

1911^{7/} -- that insurance companies could not adequately price their product so as to preserve their solidity. A Senate Committee has questioned the factual support in the Merritt Committee Report for these findings,^{8/} and other sources have attributed the problems of this period to the inability of insurers to control the rates being charged by their own agents.^{9/}

Modern experience has shown that the conditions in today's market do not promote cutthroat competition:

-- Today there is no question that insurance companies can control the rates quoted by their own agents.

-- The 1961 Senate Judiciary Report on the Insurance Industry concluded that "criticism of destructive rate wars and ruinous price competition can have little authority today in approaching the revolutionary marketing developments which have occurred

^{7/} New York, Investigation of Corrupt Practices and Insurance Companies Other Than Life, Assembly Doc. 30 (1911).

^{8/} Senate Judiciary Report No. 831, August 29, 1961.

^{9/} Wandell, The Control of Competition in Fire Insurance 11-12 (1935).

in insurance in the last few decades."^{10/}

-- Sixteen years later, in February of this year, the New York Insurance Department concluded that the experience with open competition in that state had left "no evidence" of cutthroat competition. This report concluded:

"... competitive pricing has not created destructive price wars and consequent insolvencies. Recent insolvencies, as in the past, are primarily attributable to managerial failings and poor underwriting experience and not to persistent rate inadequacy. While rate redundancy might keep a foundering and badly managed insurer afloat somewhat longer, this should not be an objective of insurance regulation . . ."^{11/}

While the fear of destructive price wars may be worrisome to some companies, it is significant that in many areas, large national writers such as State Farm experience their most vigorous price competition from small, well-managed companies operating in local markets.

^{10/} Senate Judiciary Report No. 831, 87th Congress, August 29, 1961.

^{11/} "The Open Rating Law and Property-Liability Insurance - An Evaluation of Insurance Price Regulation", prepared by Thomas A. Harnett, Superintendent of Insurance, State of New York Insurance Department, at p. 88.

4. Rate Regulation is Not Needed to Prevent Excessive Rates

Rate regulation is not essential to protect the consumer. Experience in states where competition has been allowed some measure of freedom shows that the market works to keep prices from going too high.

Significantly, the February, 1977 report of the New York Insurance Department concludes that prior approval rates would have been higher than the rates achieved by competition:

" . . . competitive pricing, by spurring companies to independently price their products, has effectively destroyed the cartelized type of price setting system that flourished under the old prior approval system;

" . . . if such independence in pricing had not taken place, prices would probably be higher than they are today because bureau-recommended rates are set at levels that protect even the least efficient, high cost company. Independence in pricing, thus tends to provide strong incentives to control losses and expenses." ^{12/}

Similarly, the Illinois Insurance Department has recently concluded that under Illinois' competitive rating system:

^{12/} Id. at p. 87.

" . . . Illinois automobile insurance rates do, in general, compare favorably with rates in other states of similar size. Left to their own initiative, companies operating in Illinois have, on the whole, soundly applied their rate structures . . . "13/

These findings are consistent with the Justice Department determination that:

" . . . unrestricted price competition can provide an effective substitute for rate regulation as a means of achieving reasonable prices and a maximum efficiency in the sale and distribution of insurance."14/

5. Rigid Rate Regulation Restricts Insurance Markets

As we have noted, rate regulation is not essential to protect the consumer. Indeed, ironically, rigid rate regulation has frequently worked against the consumer.

In the public interest, insurance companies must respond promptly to higher costs by raising rates, and equally promptly to lower costs by lowering rates.

13/ "Illinois Automobile Insurance Rate Study," State of Illinois, Department of Insurance, May, 1977, at p. 6.

14/ Justice Department Report at p. vii.

The duration of insurance contracts naturally inhibits motion in either direction. But the time involved in rate regulation slows the process even more, with adverse effects upon the industry and the public.

In periods when losses are increasing sharply, companies must be permitted to adjust their prices to secure needed revenues. Pricing in today's inflationary climate poses perhaps the most difficult problem facing insurance management. When these difficulties are compounded by the need to accommodate to political and regulatory pressures, management's prerogatives for control over pricing are often effectively nullified.

Without the opportunity for adequate revenues insurance companies face serious economic consequences, and the public is adversely affected by the sharply curtailed availability of insurance. In commenting upon the highly unprofitable years 1974-1976 -- the worst period in the history of the property and casualty business -- the New York Insurance Department in its February report has stated:

"The inability of insurers writing automobile coverages to adjust their rates during the past three years of rapidly rising losses and declining profitability has been the prime cause

of restricted markets."^{15/}

In laymen's terms, "restricted markets" means the worst of all possible worlds: people needing insurance have great difficulty obtaining it in the voluntary market.

6. State Experience Shows that Competition Works

State experience with rating laws which rely on competition clearly demonstrates the public benefit of price competition. The findings of the Justice Department are by no means unique. Recent studies by three of the largest and most professional of the state regulatory bodies -- New York, California and Illinois -- have come to similar conclusions.^{16/}

Presently, Illinois has no rating law applicable to property and casualty lines, other than workers' compensation insurance; the public there is greatly

^{15/} New York report, February, 1977, at p. 87.

^{16/} "Competition Under the California Rating Law and Its Effect on Private Passenger Automobile and Homeowners Insurance" prepared by Lynn O. Borchert, Department of Insurance, State of California, July 15, 1974; Report of the New York Insurance Department to the Governor and State Legislature, "Cartels v. Competition: A Critique of Insurance Price Regulation" (1975); "Illinois Automobile Insurance Rate Study," State of Illinois, Department of Insurance, May, 1977.

benefiting from price competition unencumbered by any state rating law. This has been confirmed by the 1977 report of the Illinois Insurance Department,^{17/} which concludes:

"In light of the data gathered in this study and supported by the findings of the others cited, perhaps the most significant conclusion one can draw is that competition is a good and viable market force. The price variances documented in the Tables certainly illustrate that the larger companies are competing on a nationwide basis. Further, competition among insurers in this State does, for the most part, exist and Illinois automobile insurance rates do, in general, compare favorably with rates in other states of similar size. Left to their own initiative, companies operating in Illinois have, on the whole, soundly applied their rate structures since August 1971. . . ."^{18/}

17/ "Illinois Automobile Insurance Rate Study," State of Illinois, Department of Insurance, May, 1977, at p. 6.

18/ This Departmental report squares with the impression of the former Illinois Insurance Director, set forth in the Justice Department Report, pp. 33-34, that in Illinois:

"The effect on insurance availability has been favorable from the public's point of view. The low population of our assigned risk plan for automobile insurance demonstrates this;

"As far as one can tell, there has been a reasonable dispersion of price of personal lines of insurance coverages;

"There appears to have been a diverse timing of price changes evidencing

Similarly, the New York Department found in its 1977 report:

"The competitive pricing law has continued to demonstrate that reliance on the forces of the marketplace can provide an orderly insurance market at prices which are reasonable in relation to other goods and services and at profits which are not excessive in relation to both equity and risk. The Department believes that a total return to prior approval would be retrogressive, impairing the efficiency of the Department and stifling the marketplace. Further, the public interest would best be served by returning the automobile lines to open competitive rate regulation."

We believe that an analysis of the industry's experience clearly demonstrates that in good times and

[Footnote continued]

independence of pricing, innovation, experimentation and risk taking;

"There appears to have been an increase in the number of uninsureds in the Illinois automobile market, presumably due to affordability [sic] problems;

"Most insurers appear to have adapted well to the new legal climate and to like it; and

"No noticeable diminution of market share of small companies has occurred."

bad, rate regulation has imposed price rigidities to the detriment of both the consumer and the insurer. Thoughtful studies demonstrate that the public is best served by relying upon competition, rather than regulation, in the pricing of personal lines of insurance.

These studies, together with the Justice Department report, demonstrate conclusively, we believe, the great benefits to the insurance consumer flowing from competition in the pricing of insurance. To maximize those benefits of competition, we support an amendment to the McCarran Act to deregulate insurance rate making, making it subject only to the pressures of the marketplace and the strictures of the federal antitrust laws.

7. State Farm's McCarran Act Proposal

Although we have long worked for so-called open competition state rating laws and continue to do so, by the late 1960's we had become convinced that in most states competitive rating laws would not be enacted or administered to maximize the benefits of vigorous competition. In 1967, State Farm first publicly called for the consideration of an amendment to the McCarran

Act to deregulate and apply the federal antitrust laws to the pricing of automobile insurance.^{19/} This position of State Farm was again expressed in testimony before the Senate Antitrust Monopoly Subcommittee in 1969. We now believe that the considerations which led us, in 1967, to propose an amendment to the McCarran Act covering automobile insurance are equally applicable to all personal lines of property and casualty insurance.

Rather than the approach taken by S. 1710 and the approach suggested by the Justice Department, in achieving these kindred objectives we propose the following:

1. The McCarran Act should be amended so as to deregulate insurance pricing -- rates, rating plans, rating territories, rating classifications and policyholder dividends -- for the personal lines of property and casualty insurance, including automobile insurance and homeowners insurance, and for very limited, related commercial lines. Deregulation would be accomplished by necessary preemption of state

^{19/} Donald P. McHugh, Address to S. S. Heubner Foundation of the University of Pennsylvania (1967).

rating laws. Our amendment to the McCarran Act would leave intact the authority for states to regulate comprehensively the business of insurance in almost all respects, including regulation relating to solvency, licensing of companies and agents, the insurance contract, complaints and unfair trade practices.

The federal antitrust laws would be applicable to activities involving rate making in these lines of insurance. The enforcement responsibility under the antitrust laws would be the only federal involvement. Essentially, this would mean prosecution by means of criminal or civil suits in federal court against insurance companies or organizations which act collusively to unreasonably restrain interstate commerce in the sale of property and casualty insurance. There would be no federal regulatory bureaucracy created to review, approve, or disapprove rates.

2. Although the federal antitrust laws would be made to apply to rating activities for these property and casualty lines, we would exempt joint collection of loss statistics and

joint collection of data relevant to the identification, prevention or reduction of losses.

3. The amendment would contain a qualification which permits state regulation and private joint action in the establishment and operation of residual market plans for these lines, with attendant antitrust immunity. Residual market plans would be prohibited from charging rates which could adversely affect the voluntary market.

4. To assist in developing shopper's guides and otherwise making rating information readily available to consumers, states would be authorized to require the filing of insurance price information on these coverages after insurance rates have been placed into effect.

This approach is somewhat different from the approach suggested by S. 1710 and the Justice Department. The major differences are:

1. Our plan would have mandatory application to all insurance companies writing

covered lines of insurance. We believe that the public cannot get the full benefit of price competition if companies have the choice of either vigorously competing under the antitrust laws or remaining under state rate regulation.

2. Only personal lines of property and casualty insurance (and certain very closely related commercial lines) would now be covered by our proposal. At present, the greatest consumer stake is in price deregulation in the personal lines market -- the segment of the market where rate regulation has done the most mischief and where the public is least able to protect itself. Notwithstanding the views of the Justice Department contained in its report,^{20/} some of the practices necessary for effectively operating the commercial lines insurance business do, in our opinion, raise serious antitrust questions. We believe that some additional consideration must be given to these unique problems before a decision is made on the extent and manner of price deregulation in those lines.

^{20/} Justice Department Report, see pp. 188-249.

3. Certain limited joint activities in the gathering of statistics should be specifically allowed. Although the Justice Department states in its report that the gathering of pure loss statistics would not violate the antitrust laws,^{21/} we believe the issue is somewhat clouded. The gathering of loss statistics is particularly important for smaller companies. Even though for our major lines we do not use loss data of others in compiling our own rates, some companies rely upon joint loss data in calculating their own rates. As long as the joint gathering of statistics and joint research is kept to a minimum, we see little danger that this activity will adversely affect the public interest, and an appropriate exemption from the antitrust laws should be provided.

4. Our proposal deals only with insurance pricing. It would be implemented without

^{21/} Justice Department Report, see pp. 167-87.

pricing. It would be implemented without involvement of any federal agencies, other than those agencies which enforce the antitrust laws.

Our proposal would exploit the partnership benefits flowing from our federal system by entrusting to each partner responsibilities it is best equipped to discharge. Policing the marketplace to guarantee that competition works as it is supposed to is left to the federal government with its special expertise and long-established experience in enforcing the antitrust laws. On the other hand, the states would continue their regulation over the policy contract, insurance company relationships with policyholders, and preserving the solvency of the insurance mechanism.

Attached, as Exhibit 1, is the statutory language to implement our proposal to amend the McCarran Act.

II. COMPETITION AND INSURER SOLVENCY

1. Rate Regulation Is Not Essential to Solvency

Sometime during the nineteenth century, the myth appears to have grown in the fire insurance business that maintenance of "adequate" rates, enforced through

private concerted activities ultimately sanctioned by state law, was necessary to prevent ruinous rate competition and consequent insurer insolvency.^{22/}

Recent history reveals that such a view is no longer valid, if, indeed, it ever was. There have, of course, been many insurer insolvencies during the past 20 years. A number occurred in Illinois, almost all of them during the period when a prior approval law was in effect -- not after the open competition rating law was enacted, nor later when there was no rating law. In the late 1960's, the Senate Antitrust Subcommittee reviewed the Illinois insolvencies and others; it concluded that fraud, corruption or mismanagement were the causes, not rate inadequacies. Insolvencies have occurred in California, but there was no indication that these insolvencies were caused by the vigorous competition which has existed there since 1947 under the open competition rating law.^{23/}

In 1975, the New York Department reviewed

^{22/} Wandel, "Control of Competition in Fire Insurance," 1935, p. 11.

^{23/} See comments in New York Insurance Department Report entitled "The Public Interest Now in Property and Liability Insurance" (1969) at 129.

experience under a New York rating law which relied more heavily on competition than had previous laws and, in analysing companies which were having financial difficulty, concluded:

"An analysis of these problem companies failed to indicate that the competitive pricing law has been the cause of their difficulties. Although some of them found themselves weakened as a result of competition, their competitive difficulties were generally of long duration and most had weaknesses which were not at all traceable to competitive factors in New York State. Their financial difficulties were largely traceable to longstanding management failings, exacerbated in many instances by the sharp decline^{24/} in stock prices in 1973 and 1974."

As a matter of fact, rate regulation has increased insurance company difficulties in the solvency area.

As the Department of Justice Report pointed out:

"Ironically, rigid rate regulation, rather than unbridled competition, appears to have had an adverse effect on the stability and solvency of insurers because 'it makes rates unresponsive to changing market circumstances' and thereby exacerbates a company's financial difficulties."

^{24/} Report of the New York Insurance Department to the Governor and State Legislature, "Cartels v. Competition: A Critique of Insurance Price Regulation," (1975) at p. 81.

(Quoting the 1969 New York Insurance
Department Report.) ^{25/}

We certainly see no reason to deny the insurance-buying public the benefits of vigorous competition because of an exaggerated fear of its impact on insurer solvency.

2. Withdrawal of Weak Companies in a
Competitive System Need Not Harm
The Public

If price competition increases by reason of adoption of our proposal, companies will continue to retire, for one reason or another, but there is no reason to assume that the percentage of out-and-out failures, with resulting policyholder and guaranty fund losses will increase. The crucial need is to establish a system which will protect the assets of companies which do not make it in the marketplace, so that they may withdraw from the field or may be quietly liquidated without loss to their policyholders or significant cost to other policyholders through guaranty fund assessments.

Competition in the insurance field, which began in earnest during the 1950's and increased in vigor

^{25/} Department of Justice Report at p. 343.

during the 1960's, has resulted in the elimination of a large number of insurers. However, these insurers have withdrawn quietly, with little or no fanfare and with practically no impact on the vigor of competition among companies remaining in the field. Although the Antitrust and Monopoly Subcommittee of the Senate Judiciary Committee publicized figures showing that 110 insurance company insolvencies had occurred during the period from 1958 to 1967 -- and there was admittedly considerable hardship because of these insolvencies -- more companies left the field for other reasons during that same period. Many companies withdrew from the market because they just couldn't cut it. The editors of Best's Insurance Reports, in mid-1964, discussed the underwriting problems of the industry and had this observation:

"The seriousness of the deterioration in underwriting results in the United States is underlined by the decisions of such worldwide underwriters as the Norwich Union, Scottish Union and Yorkshire groups to withdraw their long-established United States branches and the decision of the venerable Springfield group to reinsure the bulk of its property and liability insurance business."^{26/}

^{26/} Best's Insurance Reports, Fire and Casualty, 1963, Alfred M. Best Company, Inc., p. ix.

These and other withdrawals from the property and liability insurance business occurred without policyholder hardship. Best's 1967 Reports listed a total of 678 companies retiring from the business during the 10-year period 1958 through 1967. These companies retired through mergers, consolidations, withdrawals and both orderly and forced liquidations; however, only 110 were insolvencies involving loss to the consumer. Similarly, the 10-year period 1968 through 1977 witnessed 438 insurer retirements, of which between 80 and 90 involved loss to insureds, claimants and guaranty funds.

Attempting to limit the number of insurance company insolvencies is, of course, a legitimate governmental policy. The public impact of insurance company insolvencies does make insurance different from many other businesses. Unlike most other businesses, when an insurance company becomes insolvent, many of its customers are left without delivery of the service they had purchased -- a promise to pay future claims.

However, we are convinced that this legitimate government concern need not be pursued at the expense of vigorous price competition. The Department of Justice conclusion on this score puts solvency regulation in

perspective:

"The discussion above indicates our belief that the transition to a highly competitive marketplace may require a shift in policy from preserving at all costs the viability of each individual insurer to the swift detection and removal of a failing company from the marketplace, and the meeting of its responsibilities by absorption of its business by the industry at large (e.g., through merger or policy transfers) or by a last resort guaranty fund. After all, the important consideration from the public's standpoint is not the preservation of any one company, but rather the preservation of a reliable insurance mechanism." ^{27/}

III. SOLVENCY REGULATION

We commend Senator Brooke for presenting a novel and provocative approach to insurance regulation; we are hopeful that this Committee will provide a continuing opportunity to discuss the crucial problem of regulating for insurer solvency.

State Farm, of course, has an overriding concern with solvency matters because of the impact of insurer insolvency on the public and particularly on our policyholders. Through the post-insolvency guaranty

^{27/} Justice Department Report, see pp. 354-55.

fund assessment system, State Farm has paid approximately \$12 million in assessments, which has led to an increased cost of insurance to our policyholders. We do not deny the public benefits of this system in reimbursing consumer losses, but we would point out that it is anticompetitive in nature, inasmuch as it requires insurance companies to pay the claims of their insolvent competitors. This anticompetitive impact can be minimized by limiting the need to draw on guaranty funds. Therefore, the important question is whether a system can be devised to minimize the number of insolvencies, and then to provide for an orderly withdrawal of companies, under the aegis of the insurance department and without necessity for the implementation of the post-insolvency guaranty fund system, except in rare instances.

1. Improvement of State Solvency Regulation

We have carefully considered the proposals of S. 1710 to establish a federal mechanism for reimbursement of consumer losses from insurer insolvency, the regulatory and supervisory authority in connection therewith, and, to a lesser extent, the prevention of insolvencies. It is our present judgment that these

problems, and the mechanisms to solve them, can be handled at the state level -- but only if the states undertake expanded and accelerated efforts in this area. There are tools at hand for states to improve their record. There is a heavy burden of proof on those who would displace state regulation for solvency. We have as yet seen no convincing evidence that would satisfy that burden.

We believe that if insurance departments are freed from their responsibilities in the rate regulatory area, they can direct greater efforts to preventing insolvencies and diminishing the public impact of companies which leave the marketplace. They will be better able to identify a troubled company before it becomes insolvent and either assist it in correcting its problems or help it withdraw from the market through merger, reinsurance or orderly liquidation.

Further, the potential domino effect of the post-insolvency assessment fund can be substantially alleviated if all states with a substantial number of domestic insurers enact Access to Assets legislation, which authorizes the use of assets of the company in liquidation by the guaranty fund. This reduces the

immediate cost of an insolvency to guaranty fund members and their policyholders and substantially lessens the danger of a domino reaction, even from the insolvency of a very large insurer. Although 16 states have enacted this legislation, many important states have not yet acted.

2. An Additional Tool -- Policyholder Security Account

In order to improve regulation for solvency we also offered to the Antitrust and Monopoly Subcommittee in 1969 our so-called custodial account proposal -- since renamed the Policyholder Security Account.^{28/} The proposal is designed to accomplish two goals: First to provide an early warning of impending difficulty. Second, to protect the assets of insurers and thus either preserve solvency or at least guarantee the availability of a significant amount of marketable securities to pay claims and reduce the obligations of the guaranty funds, should liquidation become necessary.

The Policyholder Security Account legislation

^{28/} Exhibit II, attached, is a description of this proposal.

which we advocate would require insurers to "cover" their policyholder obligations (represented by loss, loss adjustment expenses and unearned premium reserves) with assets meeting the definition of "marketable securities." These assets would be segregated with a custodian (a bank with trust powers), subject to periodic reporting to the insurance commissioner. Whenever the Policyholder Security Account falls below the required amount, the regulatory authority would be advised and would take appropriate action to restore the account or to institute other statutory action authorized as respect companies in financial difficulty. This would provide the insurance commissioner with an "early warning," a most valid concept recognized in §. 1710.

We believe that states should utilize this device as a prime element in an expanded oversight of solvency problems; its value is demonstrated quite dramatically by the experience of the State of New York with its Alien Insurers' Trust Fund Law.^{29/} This act has been on the books since the first decade of this century and is quite similar to the Policyholder Security Account

^{29/} New York Insurance Law Sections 96 and 99.

proposal, except that the assets covering liabilities of the U.S. branches of alien companies are impressed with a trust rather than being held under a bailor-bailee or custodial arrangement. Careful investigation reveals that no U.S. branch of an alien company with its assets trusted under this act has ever become insolvent.

State Farm is hopeful that the states can and will improve their regulatory procedures so that the use of the post-insolvency guaranty fund system, which is in place and handling small insolvencies satisfactorily, will be kept to a minimum. Sixteen states have passed Access to Assets laws, and we believe that the others will do so in short order so as to avert the disastrous consequences of a giant insolvency. Finally, we trust that there has been more than enough embarrassment from companies becoming insolvent with virtually nothing but worthless assets in their portfolios that the state insurance commissioners will recognize that the Policyholder Security Account does provide an all-important "early warning." Illinois and Utah have acted, and we are confident that other states will follow their lead.

The sponsor of S. 1710 has publicly declared

that the present bill should not be viewed as the definitive answer to this problem and that exploration of the issue as provided by these hearings is needed to sample informed opinion and obtain public reaction. While this important dialogue continues, we would hope that sufficient time be afforded the states to enact Access to Assets and Policyholder Security Account legislation. More important, if this Committee should lend its support to the Congressional action we have urged in amending the McCarran Act, we could expect quickly to see the increased benefits in the solvency regulation area which would result from the elimination of rate regulation.

CONCLUSION

We believe that the Congress should move to deregulate insurance pricing. The need and the public benefits are clear. As to the solvency issue, we believe there is not yet a clear demonstration of need to alter the present reliance on state regulatory officials. If states no longer need to direct their attention to rate regulation, they will be able to be more vigilant and creative in their efforts to prevent insolvencies or to reduce their impact.

Insurance rate regulation and insolvency, although related historically, are not so intertwined that they must be dealt with at the same level of government or by the same regulatory body. Only if under the new configuration, where competition is allowed to set rates, state regulators demonstrate that they are still unable to deal effectively with insolvencies, should Congress seriously consider adopting an approach to the solvency problem similar to the one suggested in S. 1710.

EXHIBIT I

STATE FARM DRAFT -- McCARRAN ACT AMENDMENTS

To express the intent of the Congress with reference to the business of insurance.

The Congress hereby declares and reaffirms that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.

SEC. 2. (a) The business of insurance, and every person engaged therein, shall be subject to the laws of several States which relate to the regulation or taxation of such business.

(b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: Provided, that after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

(c) After December 31, 1976, notwithstanding the provisions of Subsection (a) of this Section, rates, rating plans, rate classifications, rate territories and policyholder dividends for or pertaining

EXHIBIT I (Continued)

Page 2

to insurance services provided by a person other than any State or any agency thereof protecting the interests of persons in and arising out of the ownership, maintenance or use of, motor vehicles, property used for residential purposes, and other property used for personal as opposed to commercial purposes, shall not be fixed, established, maintained, approved, disapproved, or directly regulated by any State.

(d) Nothing contained in this Act shall be construed to prohibit any State from establishing or approving a plan to assure the availability of insurance services as described in Section 2(c) of this Act to persons who desire such insurance services but who cannot readily obtain such insurance services. Such plans may contain provisions permitting the State to approve or disapprove rates, rating plans, rating classifications and rating territories for insurance services provided pursuant to such plan: Provided that no such plan shall permit the disapproval of rates which reasonably anticipate losses and expenses to be incurred in providing insurance services through such plans.

SEC. 3. (a) Until June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, and the Act of June 19, 1936, known as the Robison-Patman Antidiscrimination Act, shall not apply to the business of insurance or to acts in the conduct thereof.

EXHIBIT I (Continued)

Page 3

(b) Nothing contained in this Act shall render the said Sherman Act inapplicable to any agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation.

(c) After December 31, 1976, nothing contained in this Act, nor any provision of State law or regulation issued thereunder, shall render the said Sherman Act inapplicable to any agreement, understanding or concert of action between or among persons providing insurance services as described in Section 2(c) to fix, establish or maintain rates, rating plans, rate classifications, rate territories, and policyholder dividends.

(d) Notwithstanding any provision in this Act to the contrary, the said Sherman Act shall not be applicable to any agreement, understanding or concert of action limited to the collection and use of statistics on loss experience or to the discovery, identification, classification and use of information relating to causes or prevention of losses.

(e) After December 31, 1976, nothing contained in this Act shall be construed to prohibit any State from requiring persons providing insurance services as described in Section 2(c) of this Act to file with an appropriate state agency its rates, rating plans, rating classifications and rating territories, after they have been established and placed into effect.

EXHIBIT I (Continued)

Page 4

SEC. 4. Nothing contained in this Act shall be construed to affect in any manner the application to the business of insurance of the Act of July 5, 1935, as amended, known as the National Labor Relations Act, or the Act of June 25, 1938, as amended, known as the Fair Labor Standards Act of 1938, or the Act of June 5, 1920, known as the Merchant Marine Act, 1920.

SEC. 5. As used in this Act, the term "State" includes the several States, Puerto Rico, Guam, and the District of Columbia.

SEC. 6. If any provision of this Act, or the application of such provision to any person or circumstances, shall be held invalid, the remainder of the Act, and the application of such provision to persons or circumstances other than those as to which it is held invalid, shall not be affected.

MODEL POLICYHOLDER SECURITY ACCOUNT STATUTE

SECTION 1 -- Definitions

"Affiliate" and "control" shall be defined as such terms are defined in

Section (refer to the provision of the Model Holding Company Act which defines these terms).

"Commissioner" means the Commissioner of Insurance of the State of

"Custodian" means any of the following:

- (a) The Commissioner.
- (b) The insurance commissioner or state treasurer of any other state.
- (c) Any one or more national or state banks located anywhere in the United States having trust powers and which agree with the insurer establishing the Policyholder Security Account to:
 - (1) furnish to the Commissioner, on or before the last day of April of each year, on behalf of the depositor, a certified schedule of cash and marketable securities in the Policyholder Security Account, as of April 15 of that year, and at such other times as the Commissioner shall request;
 - (2) furnish monthly to the Commissioner a certified schedule of all transactions affecting such account during the preceding month, or more or less frequently as the Commissioner may require;
 - (3) cooperate with the Commissioner in the performance of the audit or valuation conducted pursuant to Section 5; and

- (4) give notice to the Commissioner, when required, pursuant to Section 7. The transaction schedules shall be kept confidential.

No bank is eligible to become a custodian for an insurer which is affiliated or under common control with such bank.

"Written premium" means direct written premium plus reinsurance assumed minus reinsurance ceded if such ceded reinsurance complies with the requirements of Section 4 of this Act.

"Insurance Company" means any corporation, association or exchange which is authorized to write the kinds of insurance to which the _____ Insurance Guaranty Association applies.

"Marketable Securities" means any of the following:

(Then should be listed those sections of the investment law which permit domestic insurers to invest in various securities. From the list of code sections selected should be eliminated any provisions which permit investment in securities of subsidiary companies, real estate, various securities secured only by mortgages or other debt obligations involving real estate, and agents' balances. A special subsection should be used to describe common stock investment as follows:)

(A) ()

()

()

() Such investments as are authorized in Section () other than stock issued by corporations described in (Subdivision (B)) on both of the following conditions:

- (1) The issuing corporation shall have net worth of five hundred thousand dollars (\$500,000) or more.
 - (2) The amount, in the aggregate, of such securities qualifying under this section may not be more than an amount equal to an insurer's capital and surplus.
- (B) The common stock, preferred stock, and debt obligations of any corporation or trust which is controlled by any one or more of the following shall not qualify as marketable securities:
- (1) The insurer.
 - (2) The insurer's affiliates.
 - (3) A person under common control with the insurer.
 - (4) The officers and directors of those companies described in paragraphs (1), (2), and (3) of this Subdivision.
- (C) The amount invested in the stock and obligations of any one corporation shall not, for the purposes of this Article, exceed 5 percent of the deposit required by Sections 2 or 3, except that as to obligations guaranteed by the United States Government, the amount invested in the obligations of any one corporation shall not exceed 25 percent of the deposit required by Sections 2 or 3.
- (D) Notwithstanding the provisions of Subdivision (A), (B), or (C), any securities shall qualify as marketable securities if the insurer has applied for and obtained from the Commissioner a certificate of exemption with respect to the specific security or securities therein described. To obtain such certificate

of exemption the insurer shall file a written application, verified as provided in Section (), in such form as the Commissioner shall require, which shall contain all of the following:

- (1) A specific description of the particular security for which the certificate is sought, including the name of the registered holder.
- (2) Copies of all agreements or other documents affecting the title thereto or any legal or equitable interest therein, contingent or otherwise.
- (3) A description of any consideration, contingent or otherwise, then unpaid.
- (4) Names, titles, capacities and business relationships of all persons or entities having an interest, contingent or otherwise, in such security other than the insurer.
- (5) A description of the legal and business relationships between the insurer and the issuer of such securities, their affiliates, subsidiaries, parents and controlling persons, including any officers and directors.
- (6) Such other information, opinions, or documents as the Commissioner may request.

"Policyholder Security Account" means an account maintained pursuant to provisions of Sections 2 or 3 of this Act.

SECTION 2

- (A) Each domestic insurance company, in order to be or remain authorized to transact one or more of the kinds of insurance

to which the _____ Insurance Guaranty Association applies, shall maintain with a

custodian a Policyholder Security Account, consisting of cash or marketable securities as required herein. The amount in the Policyholder Security Account shall not, at any time, be less than the greater of Subdivision (1) or (2), but need not exceed \$40,000,000:

(1) As respects those lines of insurance to which the _____ Insurance Guaranty Association applies, the sum of the following:

- (a) Reserves for losses due and unpaid.
- (b) Reserves for losses incurred but unreported.
- (c) Reserves for loss adjustment expenses.
- (d) Reserves for unearned premiums or

(2) 75% of the written premium for the immediately preceding calendar year for those lines of insurance to which the _____ Insurance Guaranty Association applies, less policyholder dividends and premium refunds.

- (B) The requirements of this section shall apply only to reserves, premiums and liabilities arising out of policies or obligations issued, assumed or incurred in the United States.
- (C) No credit may be taken under Subsection (A)(1) or (A)(2) for reinsurance, except in accordance with Section 4.

SECTION 3

(A) Each foreign or alien insurance company, except as otherwise authorized by the Commissioner pursuant to Subsection (D) of this Section, in order to be or remain authorized to transact one or more of the kinds of insurance to which the _____ Insurance Guaranty Association applies, shall maintain with a custodian a Policyholder Security Account, consisting of cash or investments authorized by the laws of the state of its domicile or entry, and which meet the definition of marketable securities. The amount in the Policyholder Security Account shall not, at any time, be less than the greater of Subdivision (1) or (2) of this Subsection, but need not exceed \$40,000,000:

(1) The sum of all of the following for business written in this state in those lines of insurance to which the _____ Insurance Guaranty Association applies:

- (a) Reserves for losses due and unpaid.
- (b) Reserves for losses incurred but unreported.
- (c) Reserves for loss adjustment expenses.
- (d) Reserves for unearned premiums, or

(2) 75% of the written premium for the immediately preceding calendar year for business written in this state in those lines of insurance to which the _____ Insurance Guaranty Association applies, less policyholder dividends and premium refunds.

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- (3) At the option of a foreign or alien insurance company, the amount of the Policyholder Security Account may be based on (a) business written in all of the United States or (b) business written in this state and all states with requirements substantially similar to this Act, in lieu of the amounts calculated in the manner provided in paragraphs (1) and (2) of Subsection (A) of this Section.
- (B) No credit shall be taken for reinsurance under paragraphs (1) or (2) of Subsection (A) of this Section, except in accordance with Section 4.
- (C) If the Commissioner determines that any such foreign or alien insurance company is subject to requirements substantially similar to this Act in the state of its domicile or entry, he shall accept compliance with such requirements of the state of domicile or entry in lieu of the compliance with the provisions of this Section. To be acceptable hereunder, such requirements shall include provisions similar to Section _____ of the _____ Insurance Code (new Section 19 of the Guaranty Fund Act.)
- (D) If the provisions of Subsection (C) are not applicable to such foreign or alien insurance company, the agreement between such insurance company and the custodian shall provide for a pro rata lien in favor of the Insurance Guaranty Fund of this state in substance equivalent to that provided for in Section 19.

SECTION 4

The credit for reinsurance authorized by Section 2(C) and Section 3(B) shall be limited to reinsurance cessions assumed by insurance companies which are any of the following:

- (a) Domestic reinsurers.
- (b) Foreign or alien reinsurers admitted to do business in this state and which are not affiliated or under common control with the insurer.
- (c) Foreign or alien reinsurers affiliated or under control with the insurer, and which comply with Sections 2 or 3 to the extent of the cessions.
- (d) Foreign or alien reinsurers not admitted to do business in this state and which comply with Sections 2 or 3 to the extent of the cessions.

SECTION 5

- (A) The amount of the Policyholder Security Account for each company shall be based on the reserves and written premium provided for in Subdivision (1) and (2) of Section 2(A) and 3(A) as of the last day of December of the preceding year. Each insurance company shall, on or before April 15 of each year, adjust the amount of its Policyholder Security Account to an amount no less than the amount required under this

SECTION 6

- (B) Each insurance company may, at its option, take credit for deposits of securities made with this or any other state and reported on the Special Deposit Schedule and Schedule of All Other Deposits as reported on page 15 of the Annual Statement.

The amount of marketable securities in its Policyholders Security Account may be reduced to the extent of the credit provided for in this Subsection.

- (C) Any insurance company may, at its option, apply to the Commissioner for authority to take credit for deposits of securities maintained with a custodian by underwriting associations, pools and syndicates. The Commissioner may, after such investigation as he deems necessary, permit credit for such securities to the extent that they relate to obligations in the lines of business to which the Policyholder Security Account applies.
- (D) Every year, on or before the first day of June, the Commissioner shall value the schedule of cash or marketable securities in the Policyholder Security Account for each insurance company subject to this Act to determine that it is not less than the amount required to be maintained in accordance with Sections 2 and 3. Such valuation shall consist of a review of the securities reported by the custodian to be in the company's Policyholder Security Account, plus any deposits for which the company has claimed credit under Subsections (B) or (C) as compared with the reserves and the written premiums reported in the company's Annual Statement filed with the Department.

The Commissioner may, should he deem it necessary, undertake such audit or valuation at any other time, and the insurance

company and the custodian shall cooperate in the performance of such audit or valuation. Such audit or valuation may consist of a review of a quarterly financial statement or of a report of premiums written on a twelve months-ending basis.

If the audit reveals that the company's Policyholder Security Account is deficient, the Commissioner shall take action in accordance with the provisions of Section 6.

Securities in the Policyholder Security Account shall be valued in accordance with the rules governing valuation of securities for Annual Statement purposes.

SECTION 6

If, at any time, the value of cash and marketable securities maintained with the custodian falls below the amount required to be maintained in accordance with Sections 2 or 3, the Commissioner shall require such deficiency to be eliminated by the company within a period of not more than 90 days from the notification thereof, as designated by him. Upon receipt of notice from the Commissioner of a deficiency in its Policyholder Security Account, the insurance company shall add, within the time specified by the Commissioner cash or marketable securities in an amount sufficient to correct such deficiency. Failure to eliminate such deficiency within the time specified in said notice shall be deemed to be conduct threatening to render such insurance company insolvent within the meaning of (refer to the appropriate Section of the Liquidation Act), and the Commissioner shall make and serve such order or orders as specified in such Section.

SECTION 7

- (A) Any insurance company required to maintain a Policyholder Security Account, except a company to which Subdivision (C) of this Section applies, may, at any time, substitute or exchange cash or marketable securities having a value equal to or greater than the value of those then in the account, and for which they are to be substituted or exchanged, without specific authorization from the Commissioner. Any insurance company may sell, exchange or redeem securities from the account without prior approval of the Commissioner, provided the proceeds are either retained in the account in cash or reinvested in other marketable securities of equal or greater value. All interest, dividends and other income may be withdrawn by the insurance company at its discretion. Securities in the Policyholder Security Account shall remain the sole and absolute property of the insurance company and the company may exercise all rights of ownership in such securities, subject to the ongoing requirement that it maintain a Policyholder Security Account at the levels required by this Act.
- (B) No insurance company shall make any withdrawal of principal from the Policyholder Security Account which together with previous withdrawals in the 90 days immediately preceding exceeds an amount equal to 10% of the Policyholder Security Account as last valued in accordance with Section 3 unless prior authorization of the Commissioner shall have been obtained. The agreement between the insurance company and the custodian will reflect this requirement.

- (C) In the case of any insurance company which has been required to eliminate a deficiency in its Policyholder Security Account in accordance with Section 6, the Commissioner may require 15 days prior notice from the custodian of any withdrawal, substitution, or exchange of cash or marketable securities. Such requirement of prior notice may remain in effect, at the Commissioner's sole discretion, until one year has elapsed from the time the deficiency was eliminated.

SECTION 8

Except as provided in Section (*), no interest or priority in the cash, securities, or investments maintained in a Policyholder Security Account established or maintained in compliance with the provisions of this article shall be created in favor of any person or entity.

SECTION 9

Notwithstanding any provision of this Act, the value of the Policyholder Security Account on deposit with a custodian shall be at least:

- (A) Fifty percent of the required account on or before April 15, 19__.
- (B) Seventy-five percent of the required account on or before April 15, 19__.
- (C) One-hundred percent of the required account on or before April 15, 19__.

*19 of the Guaranty Fund Act.

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AMENDMENT TO THE MODEL NAIC INSURANCE GUARANTY ASSOCIATION ACT**Section 19 - Lien on Policyholder Security Account of Insolvent Insurer.**

- (1) Upon the insolvency of any member insurer, the Association shall have a lien on the Policyholder Security Account of the insolvent insurer to the extent of payments which may be made by the Association for covered claims.
- (2) Notwithstanding any provisions in (the Liquidation Act) and any other provisions in the _____ Insurance Code, the lien provided by this Section shall not constitute a voidable preference.
- (3) If the insolvent insurer is a domestic insurer, the liquidator shall recognize a lien in favor of the Insurance Guaranty Association of any other state in which such insurer does business, to the extent of its pro rata share of such Policyholder Security Account, if the Guaranty Fund Act and the Policyholder Security Account Act of such other state contain similar provisions recognizing a pro rata lien in favor of the Insurance Guaranty Association.
- (4) In determining the pro rata sharing of an insurer's Policyholder Security Account, the share of each state Insurance Guaranty Fund in the total Policyholder Security Account shall be equal to the ratio of the insurer's direct written premiums in each state to the insurer's total direct written premiums countrywide.

**SUBSTITUTE LANGUAGE - GRADUATED CAP FOR POLICYHOLDER
SECURITY ACCOUNT**

In Section 2 and Section 3 change the end of the first paragraph under (A) to read:

"But need not exceed the maximum amount as provided in Section 4."

Section 4. The maximum amount required in the Policyholder Security Account of any insurance company subject to the provisions of this Act, need not exceed the following:

(A) For those companies whose written premiums for the prior year did not exceed \$10,000,000, the maximum required shall be \$10,000,000.

(B) For those companies whose written premiums for the prior year was greater than \$10,000,000, but did not exceed \$25,000,000, the maximum required shall be \$20,000,000.

(C) For those companies whose written premiums for the prior year was greater than \$25,000,000, but did not exceed \$40,000,000, the maximum required shall be \$30,000,000.

(D) For those companies whose written premiums for the prior year exceeded \$40,000,000, the maximum required shall be \$40,000,000.

Renumber the present language beginning with Section 4 so as to accommodate this totally new Section 4.

SECTION-BY-SECTION ANALYSIS OF
THE MODEL POLICYHOLDER SECURITY ACCOUNT STATUTE

Section 1 - Definitions

Comments on certain defined terms:

"Affiliate" and "Control"

It is important that the concept of affiliation or control be spelled out carefully because of the disallowance of securities in an affiliate or controlled corporation and the ineligibility of a bank affiliated or under common control to act as custodian for the insurer. In attempting to provide an appropriate definition for this concept, draftsmen have gone to a model holding company statute which was prepared several years ago by an industry advisory committee and approved by the NAIC. It is believed that this is the best definition extant and it is believed that it is extremely important for the concept in the holding company act to be consistent with concepts in the Policyholder Security Account statute.

"Custodian"

Commissioner or Treasurer as Custodian

It is appropriate to authorize an Insurance Commissioner or a State Treasurer to act as Custodian. First of all, they do have funds deposited with them, and have the facilities to handle such procedure. More importantly, however, is the fact that certain special deposits are made with the Insurance Commissioner of the state or domicile and often with the Insurance Commissioner or the State Treasurer of other states. It is intended, and properly so, that special deposits should qualify as part of the custodial account. Inasmuch as the requirement applies to all admitted companies and covers the reserves for obligations in all states in which the company does business, it

is appropriate that the special deposits in any given state should qualify as part of the custodial account. In Section 5(B) there is a specific provision allowing the use of such deposits for the Policyholder Security Account.

Banks with Trust Powers

Either a state or national bank may qualify as a custodian, provided it has trust powers and agrees to the four procedures listed under (c). (These procedures will be discussed in conjunction with other provisions of the model bill.) It will be noted that the bank as custodian need not be a bank domiciled in the state of the depositor. Clearly this might be impractical for most any company and most definitely will be impractical for large companies domiciled in states which do not have substantial banking institutions capable of handling hundreds of millions of dollars of custodial deposits. Further, some companies choose to keep their securities in a financial center such as New York, San Francisco or Chicago. This should certainly be permitted, provided the four requirements set forth in (c) are met.

Requirements of the Bank

The four requirements are set forth in (c) and will be discussed in detail in the comments under Section 5. It should be noted in passing that no well-run bank used to accepting deposits from insurance companies (and most insurance companies maintain their securities in one or more banks) should have any difficulty furnishing the information and the cooperation as required in (c).

Bank as Custodian - Not Trustee

It should be noted that the bank merely receives the securities as a bailee or custodian. It is not a trustee, there is no implication that it is, and Section 8 specifically negatives the idea that there may be some such relationship. This is important in order to permit the company to have the appropriate

freedom to exchange its securities as needed, and also to avoid any substantial increase in fees because of the trust relationship. Fees of banks acting as custodians are quite reasonable, but if a trustee relationship is thrust upon them they necessarily must increase their fees substantially. Again, since no undue burden is intended for companies complying with this requirement, it is specifically determined in this model statute that such a trustee relationship is not established.

"Insurance Company"

Reference should be made to the code Section or Article setting forth property and casualty lines.

"Marketable Securities"

Investment Article. It is impossible to provide in a model bill provisions appropriate to the wide variation of state investment laws and the pattern which these laws follow. Therefore, it is suggested that each state's investment code be handled individually as appropriate. It is intended that basically cash, stocks, bonds and other "liquid" assets be used in such an account.

Common Stock. Investment in common stock is generally permitted in this proposal with the exception of stock in affiliates and the overall limit that investment in the securities of any one corporation cannot exceed five percent of the total deposit required. The problem with stock is a problem of liquidity and valuation. However, in view of the difficulty by the Valuation of Securities Office of the NAIC in connection with the insolvency of Community National Life Insurance Company several years ago, the Valuation of Securities Office has tightened substantially its procedures and this tightening will enhance the use and value of the Policyholder Security Account proposal in connection with the use of common stock in such accounts.

Bonds and Other Obligations. Investments in bonds and other obligations can be used in the account. There is a general limitation of 5% of the account in any one corporation, but this is increased to 25% if the obligation is guaranteed by the United States Government.

Real Estate. Investments in real estate and mortgages cannot be used in the account.

Investments in Affiliated Entities. Almost invariably companies which have run into difficulty in recent years have gone insolvent with a substantial portion of their assets invested in stock or other securities of affiliated companies. The room and ability to manipulate the value of these securities, the ability to exchange solid liquid assets for assets of questionable value involving subsidiary or affiliated corporations makes the potential for abuse almost unlimited. Accordingly, though the investment code of various states would, of course, continue to permit investment in such securities, the concept of the Policyholder Security Account proposal does not permit the inclusion of such investments within the definition of marketable security as applied to the Policyholder Security Account proposal.

Commissioner's Discretionary Authority. It is believed that some discretionary authority should be given to the Commissioner, and accordingly (D) provides in a rather controlled way for such discretionary authority. This permits the Commissioner to allow certain investments to be eligible for coverage in the Policyholder Security Account even though they do not come within the definition of marketable securities as set forth in (A), (B), and (C) of this definition.

One example of the need for this escape clause may suffice. There is a company which has a fairly substantial investment in so-called private placement from municipalities from the state in question. The reason for these

private placements is two-fold, (1) to obtain reasonable interest rate in tax-free obligations, and (2) to furnish capital support to municipalities which may have some difficulty in obtaining funds in the bond market. Naturally, the solidity and liquidity of these private placements vary, but some undoubtedly are almost as solid an investment as are some municipal bonds purchased on the open bond market.

Section 2 - Domestic Companies

Lines of Insurance Covered. The same lines that are covered by the Fire and Casualty Insolvency Funds are intended to be covered.

Alternate Measures for Amount of Policyholder Security Account. The basic purpose of the statute is to provide coverage for obligations to persons with claims against the company, either policy claims, third party claims, or claims for return of premium. Hence, one measuring stick involves the reserves for losses, loss adjustment expenses and unearned premium reserves.

In many insolvencies it has been found that reserves, particularly loss reserves have been understated. If there is a gross understatement of reserves then much of the protection of the Policyholder Security Account is lost. To guard against this possibility, an alternate measure is used, 75% of written premium. This latter approach is the sole measure in the present Illinois Statute (except the amount is 65%). In most cases the "reserve measure" should produce a greater amount.

It should be noted that the reserve statutes in each individual state are unique to that state. Therefore, this provision of the model bill will have to be tailored to the specific requirements in each state. It is suggested that a specific reference be made to the sections of the code which require the various reserves for losses and loss adjustment expenses and unearned

premium reserves. The requirements only apply to business written in the United States.

\$40,000,000 Ceiling. It should be noted that a ceiling of \$40,000,000 has been put on the account requirement. The reason for this is essentially that, although the requirement should cause little problem to any well-run company, nevertheless, if it applies to 100% of all reserves, regardless of the size of the company, the total amount of money in these accounts--to be audited by the Insurance Departments--will run into billions of dollars. A study of past insolvencies made by the Antitrust and Monopoly Subcommittee of the United States Senate prior to the Gateway insolvency and confirmed by the firm of Woodward and Fendiller in their review of this proposal, notes that there has been no insolvency in at least 30 years greater than 10 million dollars. A cap of 40 million should provide ample coverage for most problems which are likely to arise, unless the pattern of past insolvencies is altered drastically in the future.

Section 3

Foreign and Alien Insurers. The severe impact of the insolvency of a foreign company cannot be disputed--the Gateway insolvency dramatically demonstrates this. A truly effective program must therefore cover foreign and alien companies. A provision has therefor been added to cover alien and foreign insurers for the writings done in the state enacting the law. During the several years that this proposal has been before the industry, there has been substantial controversy as to whether or not the requirement should apply to foreign as well as domestic companies.

The fear on the part of a number of industry people involves the retaliatory laws. Some have stated that if such a law is applied to foreign

companies, the retaliatory laws of a number of states would result in requiring that accounts be established in scattered locations. We do not believe that this would be the result. The retaliatory statutes would not be applied to such a requirement and even if applied, the only result would be a requirement that an account be maintained in its home state. The liberal definition of "custodian" would permit such a result.

In addition, the statute has a provision that if a similar law exists in the state of domicile of the foreign company, a complete exemption is provided. However, in order to qualify for such an exemption, that law must recognize the lien rights of foreign insolvency funds against the Policyholder Security Account of its domestic insurers.

Section 4

Reinsurance in Affiliated Companies. It is absolutely necessary to make allowance for reinsurance if smaller companies are to maintain these accounts without undue difficulty. On the other hand, it is absolutely essential to avoid any problem of phony reinsurance with affiliates. Such arrangements have, in the past, caused difficulties. Note the problem which involved the Dealers National of Texas, and which indirectly caused the insolvency of Fidelity General Insurance Company of Illinois. Reinsurance of Fidelity General in Dealers National, removal of some of Fidelity General's prime assets to pay for the reinsurance and subsequent insolvency of Dealers combined to wreck Fidelity General. It is therefore provided in this draft that affiliated foreign reinsurers can afford credit to the insurer only if the affiliated reinsurer itself establishes an account equal to the amount of the resources which would be required were the cessions not made by the domestic insurer. All domestic reinsurers, affiliated or non-affiliated, will have to establish Policyholder Security Accounts.

Unaffiliated Reinsurers. Section 4 does not spell out the requirement that unaffiliated domestic or admitted reinsurers maintain a Policyholder Security Account equal to the reserves applicable to the cessions from a company which claims credit for reinsurance. Domestic or admitted reinsurers will, themselves, be subject to a direct requirement that a Policyholder Security Account be maintained.

Section 5.

It is, of course, important that the Insurance Department determine that the Policyholder Security Account is intact and that the values therein are sufficient to provide coverage for the various reserves and obligations of the company. Accordingly, several means of accomplishing this are established in the model statute as follows:

1. Valuation of the Account. It is noted under the definition of custodian, the custodian must furnish to the commissioner by the end of April a certified schedule of cash and marketable securities which were in the Policyholder Security Account as of April 15th. Annual statement valuation rules are used. Sometime before June 1, the Insurance Department will take the list of securities submitted and apply the rules governing valuation of securities for annual statement purposes to determine the exact amount of funds in the Policyholder Security Account and determine whether or not they equal the amount required to be covered, or reach the \$40,000,000 ceiling.

Last it be feared that the valuation problem will be a substantial burden to the Insurance Department, it should be noted that most of the companies maintaining Policyholder Security Accounts will probably place long term bonds in the account and that there will be little movement in and out of the account by these companies. This would free the Department to concentrate on those companies which have over-extended

themselves, or which may be in shaky circumstances.

2. The rules of reason apply, of course, but the commissioner is given authority to demand a schedule of the cash and marketable securities at any specific time. It has been noted by commentators on this proposal that a company which has a dishonest or reckless management has 29 or 30 days in which to manipulate its assets. This period of time occurs following the submission of the monthly schedule and before the time of the next monthly schedule of transactions is due. However, if the commissioner has the authority to go in at any time, without notice to the custodian, and demand a schedule. If the commissioner will do this on occasion, the fear of detection should deter those managements which may be deliberately intending to play games with the account.

In addition, Section 7 has a provision requiring prior approval of a withdrawal of more than 10%. If total withdrawals in a 90-day period exceed 10% of the Policyholder Security Account, the commissioner must be contacted and approval obtained.

3. Monthly report of transactions. Subsection (c)(2) of the definition of custodian requires that the custodian furnish to the commissioner monthly a certified schedule of transactions affecting the account during the preceding 30 days. Again, most companies will have little or no activity in the account during a given month, and there will be a report merely stating that no activity has taken place. However, for those companies which must remove, substitute or exchange securities in a given month, this report will go to the commissioner and his audit section will have an opportunity to consider the impact, if any, of such removal or substitution. It should be noted that banks, as a matter of routine, furnish these monthly transaction schedules as to their depositors and will merely send a copy of the transaction report to the commissioner.

4. The commissioner is permitted to allow insurers to take credit for securities maintained with a custodian by underwriting association pools and syndicates. As noted above, companies as a matter of right can take credit for securities on deposit with states.

Section 6.

Commissioners Notice. The commissioner shall require any deficiency to be eliminated within a period of not more than 90 days. It is suggested that in most cases the commissioner will select a period much shorter than 90 days. However, depending on the type of problem involved, some discretion should be given to the commissioner.

The company must respond to the commissioner's order or be subject to an order as provided for in the Rehabilitation or Liquidation Statute.

The Failure to Comply. Most states have a provision in their liquidation act which authorizes certain action by the commissioner even though a condition of insolvency has not yet been established. It is believed that reference to this section is appropriate and in almost every case, this section affords the commissioner sufficient authority to take whatever protective action might be appropriate, depending on the seriousness of the failure to maintain the Policyholder Security Account, the amount of the deficiency, other conditions existing within the knowledge of the commissioners, etc.

Section 7.

Investment Freedom. Subsection (a) spells out the fact that companies which maintain the account may, without question, without prior authority, or without any restriction whatsoever, substitute or exchange cash or marketable securities in the account. The only caveat is that the exchange must result in

securities with an equal value being exchanged for those removed from the account. The insurance company at its peril makes the decision as to the valuation - under annual statement valuation rules, when it makes the exchange.

The only general exception to this rule is contained in Subparagraph (3). Prior approval from the commissioner must be obtained for a company to withdraw, in any 90 day period, 10% or more of its account.

Elimination of Deficiency. Subsection (C) deals with those companies which have slipped and which have been required to eliminate the deficiency under the provisions under Sections 5 and 6. In this unusual case, the commissioner in his discretion may require prior notice from the custodian of any withdrawal, substitution or exchange of cash or marketable securities. It is believed that this requirement is extremely important because, although the failure to maintain the proper value in a Policyholder Security Account may have occurred out of all innocence and without any intention to reduce the account, nor without any serious financial implications, more often than not, failure to maintain the account does indicate incipient or existing problems. Therefore, the commissioner should have the right to require prior notice of withdrawal in case of the invoking of Section 6 against any individual company.

Section 8.

There are two purposes for the language of this section:

1. To spell out the inherent concept that these are not trust accounts and that the bank or other custodian merely holds as a bailee, with complete investment freedom on the part of the company within the limited restraints of Section 7(a).
2. To note that the only liens or priorities on the account are the ones given to insolvency funds.

Section 9.

Some companies might find immediate compliance with this act would require some significant change in investment policy. For this reason, the requirements are phased in over a three year period to permit an orderly change.

Section 19. [A Section in the Model NAIC Insurance Guaranty Association Act.]

The insolvency fund act is amended to give the fund a lien on the Policyholder Security Account. This lien could dramatically reduce the amount of assessments to the industry for insolvencies, and thus the ultimate cost to policyholders of well-run companies.

A provision has been included which will, it is hoped, encourage all states to enact such a law, including a lien on the Policyholder Security Account in favor of the Guaranty Funds of other states with Policyholder Security Account statutes. In any state which enacts this provision, its "domestic" insolvency fund will be given a pro rata lien on the Policyholder Security Account of any foreign company which has gone insolvent and whose state of domicile has enacted this model law.

The CHAIRMAN. Thank you, Mr. Hiestand.
Our last witness is Dr. Reinmuth. Dr. Reinmuth, go right ahead, sir.

**STATEMENT OF DENNIS REINMUTH, DIRECTOR OF SPECIAL
PROJECTS, LEAGUE INSURANCE GROUP**

Mr. REINMUTH. Thank you, Mr. Chairman.

My name is Dennis Reinmuth and I am representing the League Insurance Group of Southfield, Mich. I will keep my comments very brief.

I would like to mention that our general counsel, Mr. Jack Birkinsha, was planning to be here but he also is recovering in the hospital from surgery, so I bring his regrets.

Let me explain just a little bit about the background of the League Insurance Group which consists of League Life Insurance, League General Insurance Co., the automobile insurance affiliate. By national standard we are not very large; however, League Life is Michigan's largest domestic life insurance company providing over \$5 billion worth of life and disability protection to over 2.5 million credit union people in the States of Michigan and California and League General currently insures 100,000 motor vehicles in Michigan and three other States.

I should also mention that we are members of the American Council of Life Insurance, so therefore I guess we must be the minority of one who objected to their report; we are also a member of the National Association of Independent Insurers.

The League Insurance Group has had a long interest in this whole area of Federal versus State regulation and what I would like to do is to quote our president's, Robert Vanderbeek, testimony before Senator Hart in the Senate Antitrust Monopoly Subcommittee 10 years ago.

Here's what he said.

In a democracy there is, I believe, substantial value in having "alternatives and dispersion of power" even when the result is somewhat less efficient than with centralized control. It would seem to me that what is probably desirable is a combination of both Federal and State regulation of insurance. This is the approach used in Canada (i.e., an insurance company can have a Federal or Provincial license). It is also the approach used in regulating the banks, saving and loans, and credit unions in the United States (i.e., Federal and State charters). I believe that within the next few years many insurance executives, particularly of large companies, will recognize the desirability of certain types of Federal regulation.

In 1969 we reiterated that position during the same committee's general hearings on the insurance industry. So fundamentally, we support the concept and objectives of E. 1710, particularly the concept of a Federal insolvency fund which is prefunded rather than operating on an assessment basis.

There have been comments today about the problems with GEICO. I can assure you that 2 years ago many companies, including our own, were very concerned with respect to that situation, and because of the nature of the State insolvency funds operating on a postassessment, we would have been subject to assessments right at the point

of time when we were having financial problems because of the difficulties during that period. So I think it would have had a serious impact if GEICO was allowed to go under. Of course, GEICO did survive and we are all happy about that, but I think we have to be concerned in the future that we do not let policyholders suffer because of something like that, and particularly of the impact on small companies and a lot of large companies.

We also support the Federal chartered idea. As I pointed out in Mr. Vanderbeek's comments or statement, we are used to that concept with credit unions being both federally chartered and State chartered. We think the concept of financial regulation by the Federal Government automatically comes with the Federal solvency guarantee, and we believe that makes sense. That doesn't mean that we don't have specific comments and suggestions to make and part of the statement includes two letters that were sent to Senator Brooke and Senator Proxmire outlining some of our specific comments on the bill.

We recognize that no bill is perfect, and we hope that you and your staff will examine our comments. I'd say most of our suggestions involve the very tricky area of the relationship of State versus Federal authority, but I believe that particular problems can be worked out in a good bill.

So that, in essence, is our position, and we would be happy to give any assistance we can. Thank you.

[Complete statement follows:]

STATEMENT BEFORE THE U.S. SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS ON
S.1710, "THE FEDERAL INSURANCE ACT OF 1977"
WASHINGTON, D.C., SEPTEMBER 14, 1977

BY DENNIS F. REINMUTH, Ph.D., C.L.U., C.P.C.U.,
ASSISTANT TO THE PRESIDENT AND DIRECTOR OF SPECIAL PROJECTS
LEAGUE INSURANCE GROUP, SOUTHFIELD, MICHIGAN

My name is Dennis Reinmuth. I wish to offer testimony in support of S.1710 on behalf of the League Insurance Group. League Insurance Group, consisting of League Life Insurance, League General Insurance Company, and related service organizations, is wholly owned by the Michigan Credit Union League. League Life is Michigan's largest domestic life insurance company, providing over \$5 billion of life and disability insurance protection to over two and one-half million residents of the states of Michigan and California. League General was organized in 1969 and already is among Michigan's twenty largest automobile insurers insuring nearly 100,000 motor vehicles in Michigan and three other states.

We have a keen interest in the problems of interstate insurance operations and regulation. We have long supported the concept of dual regulation. In 1967, as part of testimony before the Senate Anti-trust and Monopoly Subcommittee under the chairmanship of Senator Hart on the subject of consumer credit insurance, our President, Robert E. Vanderbeek, suggested some form of dual regulation. I would like to quote a portion of Mr. Vanderbeek's testimony in 1967:

"In a democracy there is, I believe, substantial value in having 'alternatives and dispersion of power' even when the result is somewhat less efficient than with centralized

control. It would seem to me that what is probably desirable is a combination of both federal and state regulation of insurance. This is the approach used in Canada (i.e., an insurance company can have a federal or provincial license). It is also the approach used in regulating the banks, saving and loans, and credit unions in the United States (i.e., federal and state charters). I believe that within the next few years many insurance executives, particularly of large companies, will recognize the desirability of certain types of federal regulation."

We reiterated that position during the same committee's general hearings on the insurance industry in 1969.

S.1710, "The Federal Insurance Act of 1977", would establish a regulatory system that, to a significant degree, fulfills the objectives of protecting the interest of the insurance consumer while avoiding the confusion and wastefulness of duplication and overlap of state and federal regulatory authority. We do feel that improvements can be made to further the general objectives of S.1710. Our Secretary and General Counsel, Jack E. Birkinsha, has submitted by letter to Senator Brooke two memorandums, dated July 26, and August 1, 1977, respectively, which contain detailed comments and suggested changes in S.1710.

The suggested changes concern the strengthening of the unfair discrimination provisions of the bill; suggestions for further consideration and refinement of the interrelationship of state and federal regulatory authority; regulatory flexibility at the federal level in situations in which neither competition or the anti-trust laws is adequate; and other technical improvements in the areas of terminology, the mesh between reinsurance arrangements and federal guarantee of insurance obligations, and provisions relating to the federal guaranty system. The memorandum of

August 1, 1977, includes drafts of amendatory language for sections incorporating our proposed revisions. I would like to submit the letters and memorandums of Mr. Birkinsha for the record for your careful consideration and analysis.

We believe that enactment of S.1710 would represent a breakthrough for insurance regulation and that such a law would provide significant protection and benefit to the insurance consumer. We commend this Committee and its staff for the superlative effort evidenced in this bill.

Attachments: Letter and memorandum of Jack E. Birkinsha to
Honorable Edward M. Brooke, dated July 26, 1977.
Letter and memorandum of Jack E. Birkinsha to
Honorable Edward M. Brooke, dated August 1, 1977.



**LEAGUE LIFE INSURANCE COMPANY
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**LEAGUE
INSURANCE
GROUP**



July 26, 1977

Honorable Edward M. Brooke
United States Senate
Washington, D. C. 20510

RE: S.1710, "The Federal Insurance Act of 1977"

Dear Senator Brooke:

In devising a federal system of insurance regulation complementary to the existing system of state regulation, primary attention must be given to identifying and protecting the interests of the insurance consumer, and care must be taken to avoid creating a regulatory shield for insurance operations that serve neither the consumer interest nor the long-term interests of the insurance industry. Secondly, but nevertheless significantly, overlap of state and federal regulatory authority must be avoided to prevent the wastefulness of duplication of effort and confusion of responsibility, the ultimate cost of which would inevitably be passed on to the insurance consumer.

S.1710, "The Federal Insurance Act of 1977", would establish a regulatory system that, to a significant degree, fulfills those objectives. Enactment of your proposal would be a milestone in the history of insurance regulation premised on protection of the public interest and would provide a model for the successful integration of consumer, industry, and government interests. You and your staff are to be commended highly for this accomplishment.

Even with the regard that we have for the work that you have done to date, however, we do feel that improvements can be made to further the general objectives of your proposal.

First, to promote fair and equitable availability of essential insurance coverages on an objective basis, we feel that subsection 107(c) of the bill should be more fully addressed to the prohibition of any arbitrary and unjustifiable discrimination in the provision, classification, and rating of insurance. Second, we believe that there is need for further consideration and specification of the interrelationship between state and federal regulatory authority, both to avoid unnecessary overlap and to promote competition within the business of insurance. Third, in dealing with that interrelationship, we believe that it would be in the interest of the

insurance consumer to provide for regulatory flexibility at the federal level to deal with situations in which competition, albeit fully in compliance with the antitrust laws, does not serve as an adequate and acceptable regulator of the business of insurance. Finally, we believe that some technical improvements can be made in the bill in the areas of terminology and the mesh between reinsurance arrangements and federal guarantee of insurance obligations.

Each of these matters is dealt with in greater detail in the enclosed memorandum. We would be happy, of course, to discuss all or any of these matters with you or your staff at your convenience, and we would be most appreciative of an opportunity to present our thoughts at the hearings to be held on S.1710.

Sincerely,



Jack E. Birkinsha
Secretary & General Counsel

cc: Honorable William Proxmire

MEMORANDUM

RE: S.1710, "The Federal Insurance Act of 1977"

By: League Life Insurance Company
League General Insurance Company

July 26, 1977

Antidiscrimination

In an effort to promote revitalized adherence to the basic principles of insurance, and to assure greater fairness and equity in the availability of essential insurance coverages on an objective basis, many states have recently made significant additions to the traditional prohibitions of discrimination based upon race, religion, and national origin. Michigan, for example, now prohibits discrimination based on marital status or sex and requires that refusals to insure or continue to insure, or limitations on the amount of insurance made available, based on residence, age, handicap, or lawful occupation bear a reasonable relationship to the extent of the risk or the coverage to be issued. (M.C.L.A. §500.2027.) Other states have adopted similar measures (e.g., Ore. Admin. Rules, Rule IC-61, effective January 1, 1975), while others have extended such prohibitions to additional classifications (e.g., Ill. Ins. Dept. Rules 6 Regs., Rule 26.04, effective July 1, 1976).

The desirability and necessity of creating a uniform standard for prohibition of discriminatory practices is recognized in subsection 107(c) of S.1710. In this specific context, the requirement is applicable to all federally-guaranteed insurers to ensure non-discriminatory availability of that for which the federal government provides a significant financial backup.

Such a provision is of even more significance in the "Federal Insurance Act of 1977" in relation to the reliance upon competition as the rate regulator for federally-chartered insurers. As emphasized in the recent report of the Michigan Insurance Bureau, "Essential Insurance in Michigan - An Avoidable Crisis" (March 14, 1977), one cannot deal with questions of insurance availability and rate regulation as if they exist in separate, independent vacuums; rather, they are necessarily interrelated and interdependent and must be dealt with on that basis.

The primary thrust of Title II of S.1710 (providing for federal insurance charters) is the promotion of competition, especially as the regulator of rates, within the business of insurance. Within the context of the voluntary system of federal guarantee and federal chartering, it would be impractical and counter-productive to construct a special system for insurance availability as a counter-balance to open competition rating; federally-chartered insurers cannot, for example, be mandated to take all applicants under a full-insurance-availability type of system when state-chartered competitors are not subject to the same requirement. The federal system can, however,

go far in requiring objective, justifiable, and non-discriminatory bases for the provision, classification, and rating of insurance by federally-chartered insurers, thereby requiring that the effects of competition be fair in relation to the consumer as well as in relation to other competitors.

Unfortunately, the language of subsection 107(c) does not go quite far enough in this regard, makes the mistake of paralleling state provisions that rely primarily on "laundry lists" of characteristics, and places too much reliance on correlation, which does not necessarily describe causation, as the basis for empirical justification of the use of given criteria.

Basically, the motivation for any anti-discrimination provision is to prevent reliance on arbitrary, subjective, and unjustifiable criteria as bases for refusals to insure and in developing rates and rating classifications. Discrimination on such bases could be prohibited without specific mention of any of the types of criteria involved; however, society has properly seen fit to prohibit use of certain criteria, e.g., race and sex, even though data can be produced that objectively demonstrate at least a correlation between those criteria and insurance loss exposure.

To implement the desired objectives of prohibiting unfair discrimination and promoting a fair competitive system to a maximum degree, we would recommend substitution of the following for subsection 107(c) of S.1710:

Sec. 107.(c) It shall be unlawful for any federally-guaranteed insurer to --

- (1) refuse to insure or continue to insure, or limit the amount of coverage available to, an individual or risk on the basis of age, sex, race, marital status, national origin, or any characteristic that does not bear a statistically significant, reliable, and objective relationship to the extent of the risk or the coverage issued or to be issued; or
- (2) classify, or charge a rate or premium, unless the classification, rate, or premium is reasonably predictive of and bears a statistically significant, reliable, and objective relationship to actual and credible or reasonably predictable loss and expense experience.

Open Competition Ratemaking

By virtue of the provision of secs. 109(c), 203(a)(4), and 204(a)(4), subject to minor exceptions stated in the latter, federally-chartered insurers are exempted from state rate regulation and are subjected to the applicability of federal antitrust laws. Provision is not made

for rate regulation of any kind by the federal regulator.

Subject to the qualifications stated above concerning anti-discrimination provisions and those following, this can lead to a satisfactory and adequate system of benefit to the insurance consumer. Some of the specific provisions of the bill could be improved, however, to effect more appropriately the intent of the bill.

Indirect rate control. - Compliance by federally-chartered insurers with state laws regarding policy forms is specifically required by sec. 203(a)(4). Even though that requirement is coupled with an exception as to "laws relating to rates or premiums," the opportunity for state control over rates indirectly through regulation of forms and benefits is significant and ought to be foreclosed.

Currently, perhaps the most pervasive example of indirect rate control is found in relation to disability insurance generally and credit life and disability coverages specifically. Benefits under these coverages are generally required to be reasonable in relation to premiums charged; rates, per se, are not subject to approval by the state. This has led to forms of "loss ratio regulation" in relation to individual disability coverages and "benchmark loss ratios" and "prima facie rates" for credit life and disability coverages. It is, at best, questionable whether these forms of indirect rate regulation would be precluded by the exception to the requirement of sec. 203(a)(4), and it is safe to predict that similar forms of regulation would be made applicable to other coverages to the extent that the 203(a)(4) exception proved inadequate.

It is appropriate, in delineating the federal/state regulatory inter-relationship, to continue state authority to require the mandatory offer of certain coverages (e.g., no-fault automobile insurance) and to require or prohibit certain provisions in relation to specific types of coverages (e.g., some life insurance mandatory policy provisions, prohibition of contractual cross-references to charter or bylaws requirements, etc). It is questionable if it is necessary for that purpose to allow state retention of the power to approve policy forms especially when approval is contingent upon benefits being reasonable in relation to premiums, given that that power can be used directly or indirectly to control rates.

(Similarly, policy provisions required by the life insurance "non-forfeiture laws" mandate the use of certain mortality tables and interest assumptions, with a direct effect on reserve requirements contrary to sec. 204(a)(1) and an indirect effect on premiums charged.)

We suggest the following revision of the language of sec. 203(a)(4) (which has the added advantage of further promotion of competition within the business of insurance) and a specific exemption from

state contractual form approval requirements under sec. 204(a):

Sec. 203.(a)...

(4) that the contracts of insurance or suretyship it proposes to use are in compliance with the provision of this Act and, with the exception of (A) laws or regulations relating directly or indirectly to rates, premiums, or reserves and (B) laws or regulations that the Commission shall by rule determine to impose an unnecessary or inappropriate burden on competition in view of the purposes of this Act, that such contracts are in compliance with any applicable laws or regulation of the State or States in which the contracts are issued or proposed to be issued.

Sec. 204.(a)...

(x) which require the approval of insurance policies;
or....

Alternative rate regulation. - Sec. 204(a)(4), in exempting federally-chartered insurers from state rate regulation, provides for the retention of state authority over rates related to residual market mechanisms and those related to "any line of insurance (other than reinsurance) in which the Commission determines that the insurer completes principally for the producers' business rather than the business of the ultimate consumer." The meaning of the quoted phrase is, at best, uncertain, especially in the absence of any definition of "producers". Presumably, the exception is directed at situations in which so-called "reverse competition" results in choice of the highest-rate coverage, the classic example being in the field of credit life and disability insurance.

Any exception directed at the classic "reverse competition" situation should be more clearly drawn. Even more important, however, it should be recognized that, first, retention of state rate authority in that specific area is undesirable in view of the purposes of the act and, second, rate competition in other situations often works to the disadvantage of the insurance consumer.

First, the classic response of state regulation to "reverse competition" in credit insurance has been a system of rigid and inflexible, "bench-mark loss ratios" and "prima facie rates". Invariably, the imposition of these requirements has led to the evolution of increasingly complicated and inflexible measures designed to close the loopholes inevitably found by those who would evade the purposes of the regulation. (See, e.g., Calif. Admin. Code §§2248.1 - 2248.25; Calif. Ins. Dept. Bulls. 73-8, 73-9, 73-10, 73-11.)

The ultimate result of these developments, which have only arguably provided any meaningful long-term consumer protection, has been to prevent competition as to forms of coverage provided by insurers which wish to comply with the intent and letter of the law and to

delay or preclude introduction of new administrative systems of benefit to the consumer that do not "fit" into the inflexibly prescribed molds (e.g., outstanding-balance premium payments in lieu of single premiums). In addition, inertia and the effects of political pressure have often resulted in the imposition of demonstrably inadequate rates for credit insurance, creating significant potential for insurer insolvency and/or constriction of the market for those coverages.

Both the anti-competitive effects of traditional regulatory systems and the potential for adverse effect upon the financial stability of federally-chartered insurers are contrary to the purposes of S.1710 and, therefore, argue strongly against the inclusion of the exception found in subpart (B) of sec. 204(a)(4).

Beyond the classic "reverse competition" situation, there are other segments of the business of insurance in which competition may not, in fact probably will not, work as an effective regulator of rates, even with full compliance with the antitrust laws, and to which the exceptions of sec. 204(a)(4) will not apply. Potentially the most serious of these, in terms of adverse effect upon the insurance consumer and upon satisfactory operation of the insurance mechanism, exists within the field of personal lines property and liability insurance.

Within this area, and unique within the context of business conduct generally, the personal lines property and liability insurer, as seller, picks and chooses among those to whom sales are made, often traditionally on subjective arbitrary and un justifiable bases. Experience has proven that when rates for these lines are not subject to regulatory control, i.e. when open competition rating is introduced without more, rate "competition" quickly evolves into pricing an unwanted segment out of the voluntary market with consequent enlargement of the involuntary or "residual" market. Even in relation to the "desired" segment of the market, "competition" among insurers more often than not leads to ever-increasing complexity of rating classification systems and fragmentation of the market, making it virtually impossible for any insurance consumer to be adequately informed about available choices within the marketplace.

Although a broad antidiscrimination provision, as previously suggested, will go far in limiting the adverse consequences of such forms of competition, that is not of itself sufficient for this purpose, and it is not a satisfactory means for providing for un-contemplated and unforeseeable adverse effects of competition within specific segments of the business of insurance. Even the carefully-considered and highly-sophisticated proposal of the Michigan Insurance Bureau, "The Essential Insurance Act of 1977", recognizes the potential for difficulty within a truly competitive rating system and the necessity for imposition of alternative systems on a flexible basis.

Finally, within a system of fully competitive insurance pricing and even in the absence of "cut-throat" competition (which could be dealt with under the antitrust laws), an insurer could become so over-zealously competitive as to endanger its financial stability. In any such instance, the federal regulator, by virtue of its guarantee responsibilities, must itself have flexibility in resolving the deficiency, including the authority to remove the insurer's ratemaking from the fully competitive arena.

For all of the above reasons and due to the potential variability of situations in relation to which competition may not work as an effective regulator, as well as the potential variability, quantitative and qualitative, if the alternative established is recourse to state systems of rate regulation, we recommend that the federal regulator be given power to impose alternative methods of rate regulation when competition proves to be ineffective, on the basis of amendment of subsection 204(a)(4) and the addition of a new section, to read as follows:

Sec. 204.(a) A federally-chartered insurer shall be exempt from the provisions of the law of any State -

. . .

(4) which provide for the regulation or fixing of rates or premiums or of classes of risks established by insurers operating in that State, except regulation of any assigned risk plan or other residual market mechanism established under State law.

. . .

Sec. 20x.(a) The Commission may, subject to the requirements of section 109(a), prescribe rules and regulations that provide for the filing with or approval by the Commission of the rates or premiums or the classes of risks established by federally-chartered insurers for a specified type or types of insurance upon a finding by the Commission that, with respect to such type or types of insurance -

(1) competition is not an effective regulator of the rates or premiums or classes of risks established; or

(2) a majority of federally-chartered insurers engaged in providing such type or types of insurance, or of federally-chartered insurers providing a substantial proportion of such type or types of insurance, are competing in an irresponsible manner detrimental to the maintenance of a stable market for such insurance; or

(3) there are widespread violations of this Act or of the Federal antitrust laws as specified in section 109(c); or

(4) the purposes of this Act will thereby be more adequately and reliably furthered.

(b) The Commission may, subject to the requirements of section 109(a) and under rules and regulations prescribed by the Commission, order the filing with or approval by the Commission of the rates or premiums or the classes of risks established by a specific federally-chartered insurer upon a finding by the Commission that -

(1) closer supervision of the rates, premiums, or classes of risks of the insurer is necessary to protect the interests of that insurer's policyholders due to actual or potential impairment of the insurer's financial condition; or

(2) the insurer is competing extensively in an irresponsible manner detrimental to the maintenance of a stable market for the type or types of insurance provided by the insurer; or

(3) the insurer has engaged in extensive or repeated violation of this Act or of the Federal antitrust laws as specified in section 109(c); or

(4) the purposes of this Act will thereby be more adequately and reliably furthered.

Other Federal/State Regulatory Interrelationship

In devising any system of dual federal/state regulatory authority, it is highly desirable to avoid overlaps of that authority. Not only does overlapping involve the obvious wastefulness of duplicated efforts, it also creates potential for significant conflict in regulatory requirements on the one hand and for avoidance of responsibility, i.e., bureaucratic buck-passing, on the other; the ultimate victim of the negative aspects of both is the insurance consumer, who must also ultimately bear the monetary costs of duplication.

In dealing with the regulatory aspects of federal guarantee of insurance obligations, S.1710 resolves the federal/state interrelationship in a satisfactory manner. In relation to federally-chartered insurers, however, significant potential for difficulty can be identified within the provisions of Sec. 204, "Applicability of State Law", of S.1710. Both in identifying these problems and in suggesting resolutions of them, primary consideration has been given to the promotion of reasonable and fair competition in the business of insurance, to the ultimate benefit of the insurance consumer.

Discriminatory taxation. - Section 204(b) permits continuation of discriminatory premium taxation favoring domestic over foreign insurers so long as federally-chartered insurers are not taxed more

than the least-taxed foreign insurer of the same type. That discrimination per se, as well as the regressive nature of the insurance premium tax, is hardly justifiable. In the context of a bill primarily intended to promote competition among insurers, condonation of the discrimination, an obvious burden on full competition, is inexcusable.

One would be hard put to argue that it is unfair or inappropriate to allow a state to tax a federally-chartered insurer only to the extent of the tax burden of the insurer least-taxed by that state, whether domestic or foreign. That can be accomplished by the deletion of the parenthetical phrase - "(other than the taxing State)" - at the end of the first sentence of sec. 204(b).

Reserve requirements; reporting. - Section 204(a)(1) exempts federally-chartered insurers from state reserve requirements, an obvious and necessary corollary to exemption from state rate regulation. Section 205(b), however, provides that "policyholder obligations", for purposes of determining federal investment obligations, "includes the liabilities required to be included in the insurer's annual statement filed with insurance regulatory authorities of the State in which the insurer's principal place of business is located including, but not limited to, the unearned premium reserve, reserve required by applicable mortality or morbidity tables prescribed by the Commission, and claim or loss reserves...."

The provisions are at least seemingly inconsistent; at a minimum, the 205(b) reference should be to "reserves required to be maintained by the Commission under the authority of section 107(a)(2)."

Beyond that, however, sec. 205(b) makes explicit the otherwise implicit allowance for states to continue to require all forms of reporting presently extant, including reporting on rates, loss experience, investments, investment transactions, etc. In no other instance is the potential for duplication and conflicting requirements within the contemplated federal/state regulatory system so clear. For that reason, we recommend a new subpart (5) to sec. 204(a) to read:

(5) which requires the reporting of any data, information, or experience, except for the reporting of data, information, or experience that is necessary and appropriate to the exercise of the regulatory or taxing authority of the state from which a federally-chartered insurer is not exempted by this Act.

Other anti-competitive state requirements. - Because of the variability of state systems of insurance regulation, it is impossible to delineate all of the measures that, directly or indirectly, would act to impede full realization of the competitive system to be promoted by enactment of S.1710. An additional impossibility is the contemplation of all the measures that might be devised

to avoid the exemption of sec. 204(a) by a state reluctant to surrender its power over any part of the business of insurance. For that reason, and to ensure the fulfillment of the objectives of S.1710, we recommend the addition of another subpart (6) to the exemption of sec. 204(a):

(6) found by the Commission to unduly and unnecessarily burden competition among insurers contrary to the purposes of this Act. The Commission may prescribe by rule or regulation the laws from which federally-chartered insurers are exempt under this provision either by reference to a specific law or laws of a particular State or in terms of general applicability sufficiently clear to identify the type or types of laws of any State to which the exemption applies.

Technical Problems

Terminology. - There is some potential for difficulty in interpreting and applying the provisions of S.1710 due to the definition or lack of definition of three important words or phrases: "insurance", "guaranty fund", and "policyholder surplus" (also described as "surplus as regards policyholders").

1. "Insurance" is defined in sec. 2(9) as "a contract whereby one undertakes to indemnify another or pay a specified amount or provide a designated benefit upon a determinable contingency...." Unfortunately, this attempt to define what constitutes insurance in a general way distinguishable from other forms of business enterprises and contractual obligations is as unsuccessful as all known past endeavors, including those of the terminology task force of the American Risk and Insurance Association. The definition is so broad as to include virtually all contracts and certainly all wagering contracts; at the same time, it is at least open to question whether the definition clearly and satisfactorily covers all of the activities that are engaged in under the umbrella of insurance. Moreover, "insurance" and "insurer" are often used in the bill in combination with, and as distinct from, "surety", but the latter term is not defined and the distinction, therefore, not made clear.

The preferable resolution is to rely on existing case law and ad hoc decisions to come to define what is and is not "insurance" subject to the act by deleting the definition altogether. Also, it is suggested that use of the term "surety" be avoided throughout, "surety" thereby being dealt with as simply one form of insurance.

2. "Guaranty fund", which is not defined in the act, is used generally within it (e.g., secs. 103(c)(2), 202(a)(2)) to describe the non-stock insurer equivalent of capital and surplus of stock insurers. Although the phrase is not inappropriate, it is not

in common usage traditionally ("surplus" commonly being used to designate the non-stock equivalent of capital and surplus). In the absence of a common, formalized usage, it would be preferable to include a specific definition of the phrase in the act or to use the more common reference.

3. Similarly, "policyholders' surplus" or "surplus as regards policyholders" is used in the act, without definition, in relation to investment standards applicable to both federally-guaranteed insurers (sec. 103(j)) and federally-chartered insurers (sec. 205(c)). This usage, the two phrasings being interchangeable, is common within the non life insurance business, usually as a reference to the net sum of the balance sheet capital and surplus account of a non-life insurer, including paid-in capital and contributed and earned surplus, whether the latter is allocated to special purposes or unassigned. The usage is formalized exclusively by the fire and casualty annual statement convention blank.

Again, given limited common usage and minimal, non-statutory formalization of it, the phrase ought to be defined if it is to be used in the act; preferably more specific references to the capital accounts of insurers ought to be used instead.

Guarantee/reinsurance interrelationships. - An obligation of one insurer to another, e.g. under reinsurance assumed, is excluded by definition from the federal guarantee provision. (Sec. 2(6), incorporating the definition of sec. 2(17).) At the same time, insurance obligations of an insurer are guaranteed exclusive of the reinsured obligations of a ceding insurer... (sec. 102(e)); "reinsured obligations" is not a phrase defined by the act. However, under sec. 104, the federal regulator/guarantor is obligated to satisfy all valid "guaranteed obligations", which is not defined to be exclusive of reinsurance ceded

Altogether, these provisions create considerable confusion as to how the federal guarantee is to interrelate with reinsurance arrangements.

Generally, the object of Title I of S.1710 is to make policyholders and claimants of an insolvent insurer whole. Since a particular claimant would have little assurance of being made whole by a reinsurance recovery, and certainly no assurance of timely payment from such sources even when reinsurance recoveries were determinable on the basis of particular losses (e.g., on a quota share or excess of loss basis) it seems desirable that guaranteed payments be made without regard to reinsurance recoverable; subsequently the guarantor could seek recovery against the insolvent insurer's receiver generally or provision might be made for direct recovery by the guarantor against applicable reinsurance. The equity of this resolution is buttressed if one looks at insureds as the indirect payor of guarantee fees: Those fees are assessed as a flat percentage

of direct premiums without deduction of premiums paid for reinsurance ceded (sec. 102(e)); if the insured, as indirect payor, does not have the benefit of reinsurance ceded by the insurer, he should not bear the burden of reliance upon recoveries from that reinsurance - especially by comparison to a counterpart whose insurance is with a carrier that does not reinsure to the same extent or not at all.

If the suggested resolution is not adopted, other revisions are desirable. First, the conflict between the provisions of sec. 102(a) and sec. 104(a) should be eliminated. Second, the exclusion of reinsurance recoveries under sec. 102(a) should be clarified to relate to (1) only reinsurance directly identifiable to particular insurance obligations and (2) only reinsurance recoveries that are reliable as to amount of payment. The latter is of special importance in contemplation of situations in which a reinsurer becomes insolvent and the loss of that financial backup causes insolvency of the direct carrier; amounts owing from the reinsurer to the direct insurer are not covered by the federal guarantee (sec. 2(17)), but as written, the exclusion of sec. 102(e) could require deduction from insurance obligations of the direct carrier without regard to the inability to effect recoveries under the reinsurance ceded.


 Jack E. Birkinsha
 Secretary & General Counsel



**LEAGUE LIFE INSURANCE COMPANY
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**LEAGUE
INSURANCE
GROUP**



August 1, 1977

Honorable Edward W. Brooke
United States Senate
Washington, D.C. 20510

RE: S.1710 - "The Federal Insurance Act of 1977"

Dear Senator Brooke:

Since preparing our initial comments on S.1710, forwarded to you with my letter dated July 26, we have undertaken the preparation of a draft indicating specific suggested changes in the language of the bill in a form that makes clear what additions and deletions are proposed. A copy of that memorandum is enclosed for your consideration.

This memorandum, which, due to the length of the bill, sets out only those sections or subsections for which revisions are suggested, incorporates the suggestions made previously and also includes other proposed revisions. Many of the latter are minor and/or self-explanatory. Two matters, however, require further comment (references are to section numbers as set out in our memorandum):

Sec. 2(16). - The addition to the prefatory language would preclude guaranty of exclusively-captive insurers and of "in-house" obligations of other insurers, relieving the guaranty system from covering obligations to closely related persons, default of which would have no serious impact on the typical insurance consumer. This would not, however, preclude guaranty of third-party obligations under, for example, employee group contracts or liability policies due to the "amounts due" formulation.

The deletion of "by any insurer adjudged to be impaired or insolvent" from subparagraph (A) of Sec. 2(16) is suggested because the act contemplates identification elsewhere of "insured obligations" of solvent, non-impaired insurers (e.g., sec. 102(e)). The addition to subparagraph (A) incorporates the thrust of the phrase suggested for deletion from sec. 103(b) in a manner that more clearly defines the extent of the guaranty obligation.

Sec. 103(j). - The suggested addition would apply to voluntary surrender of guaranty certificates the requirements, with some modification, applicable in the original bill to surrenders of federal charters. Precedent for such requirements related to federal financial guaranties can be found in relation to N.C.U.A. share insurance, and the surrender of a guaranty certificate, contingent upon certification of financial condition, would seem to be of equal relevance to shareholders and/or policyholders as surrender of a federal charter. Since certification of financial condition may reasonably require some form of examination of the insurer, an extended period for provision of the certificate is allowed, both here and in the suggested revision of sec. 201(f), and similarly, since protection of the public interest might require, for example, steps to improve or stabilize the financial condition of an insurer in the case of guaranty surrender or an acceptable plan for dissolution or for chartering under state law in the case of charter surrender, the FIC is empowered to impose such requirements as conditions to approval of voluntary surrenders.

We are hopeful that these comments and suggestions too will be of some assistance in your further consideration of S.1710.

Sincerely,



Jack E. Birkinsha
Secretary & General Counsel

cc: Honorable William Proxmire

MEMORANDUM

RE: S.1710, The Federal Insurance Act of 1977

FROM: League Life Insurance Company
League General Insurance Company

August 1, 1977

SUGGESTED REVISIONS

(All capital letters indicate additions; cross out indicates deletions; omission in full indicates no change suggested in the material omitted.)

DEFINITIONS

Sec. 2. As used in this Act—

. . .

(2) the term "federally chartered insurer" means an insurer or surety chartered under the provisions of this Act to transact an insurance or surety business;

(3) the term "federally guaranteed insurer" means an insurer or surety whose insurance obligations are guaranteed under the provisions of this Act;

. . .

(8) the term "insurer" means any person which is engaged in transacting insurance or suretyship as a principal in interstate commerce or which is reinsured in interstate commerce;

~~{9} the term "insurance" means a contract whereby one undertakes to indemnify another or pay a specified amount or provide a designated benefit upon a determinable contingency;~~
[Renumber (10) as (9).]

~~{11}~~ (10) the term "net direct premiums written" means direct gross premiums AND ANNUITY CONSIDERATIONS written on policies guaranteed in accordance with this Act less return premiums thereon and dividends paid or credited to policyholders on such direct business;

[Renumber (12) and (13) as (11) and (12).]

~~{14}~~ (13) the term "policy" means any contract of direct insurance or surety, including any endorsement, binder (written or oral), cover note, certificate, or other instrument of insurance attached or relating thereto, without regard to the nature or form of the same;

[Renumber (15) and (16) as (14) and (15).]

~~{17}~~ (16) the term "insurance obligation" means any unsatisfied obligation, excluding amounts due any reinsurer, insurer, insurance pool, or underwriting association, OR ANY PERSON OWNING, CONTROLLING, OWNED OR CONTROLLED BY, OR UNDER COMMON CONTROL WITH AN INSURER, as subrogation recoveries or otherwise—

(A) which exists under and within the coverage and limits of insurance policies (i) issued by ~~any insurer adjudged to be impaired or insolvent~~ TO ANY PERSON RESIDENT, DOMICILED, OR EXPOSED TO RISK OF LOSS IN ANY STATE AND (ii) UNDER WHICH COVERAGE OF ANY RISK OF LOSS IN FOREIGN COUNTRIES IS INCIDENTAL TO COVERAGE OF RISK OF LOSS IN ANY STATE;

. . . .

TITLE I— FEDERAL INSURANCE GUARANTY PROGRAM

Sec. 101. . . .

(b)

(7) To make examinations of and to require information and reports from all federally guaranteed insurers, **FEDERALLY CHARTERED INSURERS, AND** or applicants for a guaranty or charter, their managers and agents, as required in this title.

. . . .

Sec. 102. . . .

(e) Any insurance obligation incurred or maintained ~~exclusive of the reinsured obligations of a ceding insurer~~ by a federally guaranteed insurer during a period when such insurer is authorized to do business under this Act is guaranteed and, upon the default of such insurer, such obligation shall be met by the Commission utilizing proceeds contained in the Federal Insurance Guaranty Fund. Any guaranty hereunder is a full faith and credit obligation of the United States. The Commission shall establish and collect from each insurer guaranteed under this Act an annual fee calculated as a percentage of its net direct premiums, and such fee may not exceed one-fourth of 1 per centum per year. The Commission may establish different levels of fees for different types of insurers: Provided, That all insurers of the same type shall pay comparable fees and the fees charged each type of company shall be reasonably related to expected losses. In establishing the guaranty fees to be collected pursuant to this Act, the Commission shall attempt to develop and maintain a balance in the Guarantee Fund sufficient to render unlikely any need to borrow from the Secretary of the Treasury. When the balance in the fund reaches such a sufficient level, the fee established and collected under this section may be reduced or suspended. ANY REDUCTION OR SUSPENSION OF THE FEE ESTABLISHED AND COLLECTED UNDER THIS SECTION MAY BE VARIABLE BY CLASSIFICATIONS OF INSURERS BASED UPON RELATIVE AMOUNTS OF AGGREGATE FEES PREVIOUSLY PAID BY SUCH INSURERS.

. . . .

Sec. 103. . . .

(b) Any insurer may make application to the Commission for a certificate under this section ~~which-certificate-is-in force-in-any-line-of-insurance-insuring-persons-or-risks situated-in-any-State-except-that~~ [Note— See the territorial qualification added to the definition of insurance obligations", sec. 2(16)(A).] No insurer chartered under the provisions of this Act may make, issue, renew, or continue in effect any insurance policy or otherwise transact insurance unless and until it has received a certificate hereunder.

(c) . . .

(2) a statement of the insurer's capital and surplus, in the case of a stock insurer, or guaranty-fund SURPLUS, in the case of an insurer other than a stock insurer.

. . .

(1) . . .

(4) . . .

(B) The policyholder of any policy guaranteed hereunder shall be given written notice BY THE INSURER not less than sixty days prior to the loss of guaranty status on its policy.

(J) (1) A FEDERALLY GUARANTEED INSURER MAY REQUEST REVOCATION OF A CERTIFICATE GRANTED HEREUNDER UPON THE MAJORITY VOTE OF ITS STOCKHOLDERS OR, IN THE CASE OF A NONSTOCK INSURER, THE MAJORITY VOTE OF ITS POLICYHOLDERS OR MEMBERS, VOTING IN PERSON OR BY PROXY AT A MEETING CALLED FOR SUCH PURPOSE. THE NOTICE OF SUCH MEETING SHALL BE GIVEN AT LEAST THIRTY DAYS PRIOR THERETO AND SHALL CONTAIN A CERTIFIED STATEMENT OF THE COMMISSION, PREPARED FOR SUCH PURPOSE AND AT THE EXPENSE OF THE INSURER, SETTING FORTH THE FINANCIAL CONDITION OF THE INSURER AND ITS ABILITY TO MEET ITS INSURANCE OBLIGATIONS. THE COMMISSION SHALL PREPARE SUCH CERTIFIED STATEMENT WITHIN NINETY DAYS OF A WRITTEN REQUEST THEREFOR FROM THE BOARD OF DIRECTORS OR OTHER SIMILAR GOVERNING BODY OF THE INSURER: PROVIDED, THAT IF A FINANCIAL EXAMINATION OR AUDIT OF THE INSURER IS NECESSARY IN THE JUDGMENT OF THE COMMISSION TO DETERMINE THE FINANCIAL CONDITION OF THE INSURER AND ITS ABILITY TO MEET ITS INSURANCE OBLIGATIONS THE COMMISSION MAY EXTEND THE PERIOD FOR AN ADDITIONAL NINETY DAYS

2) THE REVOCATION OF A CERTIFICATE GRANTED HEREUNDER UPON THE REQUEST OF AN INSURER MAY BE MADE UPON SUCH TERMS AND CONDITIONS NOT INCONSISTENT WITH THE PROVISIONS OF THIS ACT AS THE VOTE AUTHORIZING SUCH REQUEST MAY PROVIDE OR AS THE COMMISSION MAY REQUIRE. THE COMMISSION SHALL NOT REVOKE THE CERTIFICATE UNTIL SUCH TERMS AND CONDITIONS HAVE BEEN MET.

Sec. 103 (continued)

{j}(K) Investments of a federally guaranteed insurer, other than an insurer chartered under section 201, shall be regulated, in general, by the laws and regulations of such insurer's State of domicile and the laws and regulations of the States in which it transacts insurance unless the Commission shall determine, after hearing, that the laws or regulations of such State or States fail to require that the minimum policyholders'-surplus CAPITAL AND SURPLUS REQUIREMENTS and reserve liabilities, including the loss reserves, unearned premium reserve, and mortality reserve, of such insurer be covered, to a reasonable degree, by admissible assets of sufficient integrity and stability, or that any such insurer is not required to comply with, and does not comply with, the current investment laws or regulations of its State of domicile. Upon making such finding, the Commission shall issue such order as is necessary to bring the insurer's investments into compliance with the standards established by this section within a reasonable length of time or to terminate its status as a federally guaranteed insurer for its failure to do so. For the purpose of carrying out its functions under this section, the Commission is authorized to issue a subpoena requiring the insolvent insurer to furnish such books, records, or other materials as it deems necessary, and in the event of a refusal to comply therewith, the Commission may invoke the aid of any United States district court having jurisdiction of a district in which the insurer can be found. Refusal of insurer to obey any court order issued pursuant to any proceeding hereunder may be punished by the court as a contempt thereof.

[Reletter (k) as (l).]

(M) ANY STATE MAY BY LAW REQUIRE ALL INSURERS DOING BUSINESS IN THAT STATE TO EFFECT AND MAINTAIN A CERTIFICATE ISSUED UNDER THIS SECTION.

. . .

Sec. 107. . . .

(c) It shall be unlawful for any federally-guaranteed insurer to --

(1) REFUSE TO INSURE OR CONTINUE TO INSURE, OR LIMIT THE AMOUNT OF COVERAGE AVAILABLE TO, AN INDIVIDUAL OR RISK ON THE BASIS OF AGE, SEX, RACE, MARITAL STATUS, NATIONAL ORIGIN, OR ANY CHARACTERISTIC THAT DOES NOT BEAR A STATISTICALLY SIGNIFICANT, RELIABLE, AND OBJECTIVE RELATIONSHIP TO THE EXTENT OF THE RISK OR THE COVERAGE ISSUED OR TO BE ISSUED; OR

(2) CLASSIFY, OR CHARGE A RATE OR PREMIUM, UNLESS THE CLASSIFICATION, RATE, OR PREMIUM IS REASONABLY PREDICTIVE OF AND BEARS A STATISTICALLY SIGNIFICANT, RELIABLE, AND OBJECTIVE RELATIONSHIP TO ACTUAL AND CREDIBLE OR REASONABLY PREDICTABLE LOSS AND EXPENSE EXPERIENCE.

. . .

CHARTERING

Sec. 201.(a) The Commission is authorized to issue a charter to any stock, mutual, or reciprocal insurer, reinsurer, or surety, the United States branch of an alien insurer or surety, or any other alien insurer or surety maintaining in the United States at all times trust funds of not less than \$50,000,000 or such lesser amount as may be approved by the Commission, for the security of policyholders and claimants in accordance with such rules, regulations, and procedures as the Commission may prescribe.

(b)(1) Notwithstanding the provisions of the law of any State, any stock, mutual, or reciprocal insurer, OR Lloyds organization, or a surety, organized or incorporated under the authority of State law, having been certified by the Commission as otherwise eligible to become a federally chartered insurer and upon the majority of its stockholders, or in the case of a nonstock insurer, a majority of its policyholders or members, voting in person or by proxy at a meeting called for such purpose, shall be issued a Federal charter.

(f)(1) A federally chartered insurer may elect to surrender its Federal charter, together with all right, power, authority, and entitlements granted thereunder or incident thereto, upon the majority vote of its stockholders or, in the case of a nonstock insurer, the majority vote of its policyholders or members, voting in person or by proxy at a meeting called for such purpose. The notice of such meeting shall be given at least thirty days prior thereto and shall contain a certified statement of the Commission, prepared for such purpose and at the expense of the insurer setting forth the financial condition of the insurer and its ability to meet its insurance obligations. The Commission shall prepare such certified statement within sixty NINETY days of a written request therefor from the board of directors or other similar governing body of the insurer: PROVIDED, THAT IF A FINANCIAL EXAMINATION OR AUDIT OF THE INSURER IS NECESSARY IN THE JUDGMENT OF THE COMMISSION TO DETERMINE THE FINANCIAL CONDITION OF THE INSURER AND ITS ABILITY TO MEET ITS INSURANCE OBLIGATIONS, THE COMMISSION MAY EXTEND THE PERIOD FOR AN ADDITIONAL NINETY DAYS.

(2) The election of a federally chartered insurer to surrender its Federal charter may be made upon such terms and conditions, not inconsistent with the provisions of this Act, as the vote authorizing such election may provide OR AS THE COMMISSION MAY REQUIRE. The Commission shall not certify the surrender of the insurer's Federal charter and the date thereof until such terms and conditions have been met.

• • Sec. 202.(a)(1). . .

(2) The material filed with the Commission shall state the capital and surplus, in the case of a stock insurer, or guaranty-fund, SURPLUS, in the case of an insurer other than a stock insurer, which shall not be less than such amount as the Commission may, by rule, prescribe. No portion of such capital OR surplus or-guaranty-fund shall consist of surplus notes or any other form of direct or indirect indebtedness.

. . .

(b) No Federal charter shall be issued in the name of an insurer whose name is identical with or so similar to the name of an insurer already licensed or authorized in one or more of the United States as reasonably likely to cause confusion or be misleading or deceptive to policyholders or claimants, EXCEPT AN INSURER PREVIOUSLY AUTHORIZED TO ENGAGE IN THE BUSINESS OF INSURANCE IN MORE THAN ONE STATE UNDER THE NAME IN WHICH APPLICATION FOR A FEDERAL CHARTER IS MADE. NO INSURER SHALL USE THE WORDS "FEDERAL", "NATIONAL", "UNITED STATES", "U.S.", OR "GOVERNMENT" IN A MANNER LIKELY TO DECEIVE OR MISLEAD THE PUBLIC, AND NO INSURER SHALL USE A NAME THAT IS IDENTICAL WITH OR SO SIMILAR TO THE NAME IN WHICH A FEDERAL CHARTER IS ISSUED AS REASONABLY LIKELY TO CAUSE CONFUSION OR BE MISLEADING OR DECEPTIVE TO POLICYHOLDERS OR CLAIMANTS.

. . .

COMMENCING BUSINESS

Sec. 203.(a). . .

(1) that its capital and surplus or guaranty-fund SURPLUS has been paid in;

(2) that such capital and surplus or guaranty-fund SURPLUS has been invested in such assets as are permitted under this Act or the Commission's regulations, or are held in such deposits or custodial accounts as prescribed by the Commission;

(3). . .

(4) that the contracts of insurance or suretyship it proposes to use are in compliance with the provisions of this Act and, with the exception of (A) laws relating, DIRECTLY OR INDIRECTLY to rates, premiums, OR RESERVES AND (B) LAWS OR REGULATIONS THAT THE COMMISSION SHALL BY RULE DETERMINE TO IMPOSE AN UNNECESSARY OR INAPPROPRIATE BURDEN ON COMPETITION IN VIEW OF THE PURPOSES OF THIS ACT, that such contracts are in compliance with any applicable laws or regulations of the State or States where such contracts are proposed to be issued.

. . .

APPLICABILITY OF STATE LAW

Sec. 204.(a). . .

(1) WHICH REQUIRE THE APPROVAL OF INSURANCE POLICIES; OR
[Renumber (1), (2), and (3) as (2), (3), and (4).]

(5) which provide for the regulation or fixing of rates or premiums or of classes of risks established by insurers operating in that State, except regulation of (A) any assigned risk plan or other residual risk market mechanism established under State law; ~~or (B) any line of insurance (other than re-insurance) in which the Commission determines that the insurer competes principally for the producers' business rather than the business of the ultimate consumer.~~

(6) WHICH REQUIRES THE REPORTING OF ANY DATA, INFORMATION, OR EXPERIENCE, EXCEPT FOR THE REPORTING OF DATA, INFORMATION, OR EXPERIENCE THAT IS NECESSARY AND APPROPRIATE TO THE EXERCISE OF THE REGULATORY OR TAXING AUTHORITY OF THE STATE FROM WHICH A FEDERALLY CHARTERED INSURER IS NOT EXEMPTED BY THIS ACT; OR

(7) FOUND BY THE COMMISSION TO UNDULY AND UNNECESSARILY BURDEN COMPETITION AMONG INSURERS CONTRARY TO THE PURPOSES OF THIS ACT. THE COMMISSION MAY PRESCRIBE BY RULE OR REGULATION THE LAWS FROM WHICH FEDERALLY CHARTERED INSURERS ARE EXEMPT UNDER THIS PROVISION, EITHER BY REFERENCE TO A SPECIFIC LAW OR LAWS OF A PARTICULAR STATE OR IN TERMS OF GENERAL APPLICABILITY SUFFICIENTLY CLEAR TO IDENTIFY THE TYPE OR TYPES OF LAWS OF ANY STATE TO WHICH THE EXEMPTION APPLIES.

(b) Nothing in this section may be constructed to deny to any State the right to levy taxes or to require license fees for federally chartered insurers transacting insurance within its jurisdiction except that a federally chartered insurer has no liability to any State for a tax measured by gross premiums or net premiums collected to the extent that the amount of such tax exceeds or would exceed the amount of tax which would be imposed on the same amount of gross or net premiums of the least taxed insurer (other than a nonprofit medical or hospital-type corporation) doing the same type of business and organized under the laws of any State ~~(other than the taxing State)~~. Except as otherwise provided herein, a federally chartered insurer shall for tax purposes be taxed at no higher rate than a foreign insurer doing the same type of business in any State in which it is authorized to do business.

. . .

ALTERNATIVE RATE REGULATION

SEC. 205.(A) THE COMMISSION MAY, SUBJECT TO THE REQUIREMENTS OF SECTION 109(A), PRESCRIBE RULES AND REGULATIONS THAT PROVIDE FOR THE FILING WITH OR APPROVAL BY THE COMMISSION OF THE RATES

OR PREMIUMS OR THE CLASSES OF RISKS ESTABLISHED BY FEDERALLY CHARTERED INSURERS FOR A SPECIFIED TYPE OR TYPES OF INSURANCE UPON A FINDING BY THE COMMISSION THAT, WITH RESPECT TO SUCH TYPE OR TYPES OF INSURANCE -

- (1) COMPETITION IS NOT AN EFFECTIVE REGULATOR OF THE RATES OR PREMIUMS OR CLASSES OF RISKS ESTABLISHED OR
 - (2) A MAJORITY OF FEDERALLY CHARTERED INSURERS ENGAGED IN PROVIDING SUCH TYPE OR TYPES OF INSURANCE OR OF FEDERALLY CHARTERED INSURERS PROVIDING A SUBSTANTIAL PROPORTION OF SUCH TYPE OR TYPES OF INSURANCE ARE COMPETING IN AN IRRESPONSIBLE MANNER DETRIMENTAL TO THE MAINTENANCE OF A STABLE MARKET FOR SUCH INSURANCE; OR
 - (3) THERE ARE WIDESPREAD VIOLATIONS OF THIS ACT OR OF THE FEDERAL ANTITRUST LAWS AS SPECIFIED IN SECTION 109(C); OR
 - (4) THE PURPOSES OF THIS ACT WILL THEREBY BE MORE ADEQUATELY AND RELIABLY FURTHERED
- (B) THE COMMISSION MAY, SUBJECT TO THE REQUIREMENTS OF SECTION 109(A) AND UNDER RULES AND REGULATIONS PRESCRIBED BY THE COMMISSION, ORDER THE FILING WITH OR APPROVAL BY THE COMMISSION OF THE RATES OR PREMIUMS OR THE CLASSES OF RISKS ESTABLISHED BY A SPECIFIC FEDERALLY CHARTERED INSURER UPON A FINDING BY THE COMMISSION THAT -
- (1) CLOSER SUPERVISION OF THE RATES, PREMIUMS, OR CLASSES OF RISKS OF THE INSURER IS NECESSARY TO PROTECT THE INTERESTS OF THAT INSURER'S POLICYHOLDERS DUE TO ACTUAL OR POTENTIAL IMPAIRMENT OF THE INSURER'S FINANCIAL CONDITION OR
 - (2) THE INSURER IS COMPETING EXTENSIVELY IN AN IRRESPONSIBLE MANNER DETRIMENTAL TO THE MAINTENANCE OF A STABLE MARKET FOR THE TYPE OR TYPES OF INSURANCE PROVIDED BY THE INSURER; OR
 - (3) THE INSURER HAS ENGAGED IN EXTENSIVE OR REPEATED VIOLATION OF THIS ACT OR OF THE FEDERAL ANTITRUST LAWS AS SPECIFIED IN SECTION 109(C); OR
 - (4) THE PURPOSES OF THIS ACT WILL THEREBY BE MORE ADEQUATELY AND RELIABLY FURTHERED.

INVESTMENTS

Sec. 205 206.(a) The purpose of this section is to require that funds of any federally chartered insurer in an amount equal to the sum of its policyholder obligations and minimum capital and surplus, or guaranty-fund SURPLUS, required by law, shall be invested in assets of integrity and stability, and to provide that funds of such insurer in excess of those required to cover such policyholder obligations and capital and surplus or guaranty fund SURPLUS, may be invested at the discretion of the insurer except that such excess funds shall not be invested in assets prohibited by subsection (g).

(b) As used in this section, the term "policyholder obligations" means those liabilities of the insurer to its policyholders

and claimants against such policyholders on account of insurance contracts issued by it and obligations to creditors, and includes the liabilities required to be included in the insurer's annual statement filed with insurance regulatory authorities of the State in which the insurer's principal place of business is located including, but not limited to, the unearned premium reserve, reserve required by applicable mortality or morbidity tables prescribed by the Commission, and claim or loss reserves including reserves for incurred but not reported losses and for loss adjustment expense, AS REQUIRED BY THE COMMISSION but "policyholder obligations" does not include that portion of the insurer's capital and surplus, or guaranty-fund SURPLUS, in excess of the minimum capital and surplus, or guaranty-fund SURPLUS, required by law for such insurer.

(c) For the purpose of covering its policyholder obligations and minimum capital and surplus or guaranty-fund SURPLUS, every federally chartered insurer shall have and maintain investments of the classes described in this subsection to the extent of such policyholder obligations and minimum capital and surplus or guaranty-fund SURPLUS less an amount equal to 30 per centum of its surplus as regards policyholders THE NET TOTAL OF ITS BALANCE SHEET CAPITAL AND SURPLUS ACCOUNT, but in no event shall such insurer have and maintain investments of the character described less than in an amount equal to the sum of 70 per centum of such policyholder obligations, other than its minimum capital and surplus or guaranty-fund SURPLUS, and 100 per centum of the minimum required capital and surplus or guaranty-fund SURPLUS, except that the investments referred to in this subsection shall be subject to the limitations provided by subsection (d), and the Commission shall disallow any specific investment upon its finding that such investment does not meet the standard of unquestioned integrity and stability for the purposes of this subsection:

(1) . . .

. . .

(15) common stocks of any solvent corporation incorporated under the laws of the United States or any State or territory thereof or the District of Columbia or the Dominion of Canada or any Province thereof, if the stocks of such corporation are listed or admitted to trading on a national securities exchange located in the United States and registered pursuant to sections 6 and 19 of the Securities Exchange Act of 1934; AND

(16) SUCH OTHER INVESTMENTS AND SUBJECT TO SUCH LIMITS, AS THE COMMISSION MAY BY RULE PRESCRIBE AS MEETING THE STANDARD OF UNQUESTIONED INTEGRITY AND STABILITY.

(d) Investments made by federally chartered insurers for the purpose of covering their policyholder obligations and their minimum capital and surplus or guaranty-fund SURPLUS provided by law, as provided in subsection (c), are, with respect to such purpose only, subject to the following limitations;

(1) . . .

(8) For the purposes of the limitations contained in this subsection (d), the property and securities enumerated in subsection (c) shall be valued at market value or, IF MARKET VALUE IS NOT READILY ASCERTAINABLE, at cost less depreciation except that the Commission may, by regulation, authorize valuation of securities in accordance with stated values established for such securities in writing or as published by the Committee on Valuation of Securities of the National Association of Insurance Commissioners.


Jack E. Birkinsha
Secretary & General Counsel



September 19, 1977

Honorable William Proxmire
Chairman, Senate Committee on
Banking, Housing and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Senator Proxmire:

Re: S. 1710, "The Federal Insurance Act of 1977"

I appreciated the opportunity of testifying on S. 1710 last week. During the hearings, you raised the question with Mr. Robert Dillard of the American Council of Life Insurance whether life insurance companies were concerned about the potential affects of inflation on life insurer solvency, particularly when the inflation rate is in the double digit range as experienced in the U. S. in 1974-1975. Since I did not have an opportunity to respond to this important question, we would like to express our view on that issue.

You were quite correct in stating that high inflation rates can have a dramatic and substantial economic impact on life insurers. High inflation results in escalating company expenses. Since premiums are fixed at the time of the issuance of life insurance contracts, the expense provisions in premiums become increasingly inadequate. Secondly, high inflation rates may cause a high proportion of policyholders to cancel individual policies with savings features and/or borrow loan values. Such actions result in significant cash flows out of the company. Since life insurance company investments are generally in long-term secure investments, such outflows can cause considerable financial difficulty. Many life insurers faced such problems in 1974-1975, and were very concerned.

In late 1974, the International Cooperative Insurance Federation - an association of cooperative insurers around the world - established a "Commission on Insurance and Inflation" to examine the problems inflation was causing policyholders and insurers. This commission was chaired by our President, Robert Vanderbeek. The commission issued a report in 1976 after considerable research and study. The emphasis of the report was on identifying the problems inflation was causing and what insurers could practically do in alleviating these problems. I enclose a copy of the report for your perusal. Fortunately, the inflation rate declined, but there is no question that a prolonged period of high inflation would have been financially disastrous for life insurers.

I hope these observations will be of value to you and your committee.

Sincerely,

Dennis F. Reinmuth

Dennis F. Reinmuth
Director of Special Projects

eh
enc

cc: Honorable Edward W. Brooke

International Co-operative Insurance Federation

REPORT
OF THE
COMMISSION ON INFLATION AND INSURANCE

To Be Discussed At The
International Cooperative Insurance Federation
Conference

Paris, France September, 1976

International Cooperative Insurance FederationCommission on Inflation and Insurance

The International Cooperative Insurance Federation (ICIF) is comprised of some 72 cooperative insurance societies in 26 countries throughout the world. The objectives of the ICIF are: joint investigations, development of joint action programs, exchange of information and personnel, and establishment of international cooperative relations in matters of insurance and reinsurance.

In 1974 the ICIF established a Commission on Inflation and Insurance. The Commission studied the effect of inflation on insurers and policyholders and is recommending steps that can be taken to lessen the problems caused by inflation. Serving on the Commission were:

Mr. Donald Cornthwaite
Group Actuary
Co-operative Insurance Society, Ltd.
Manchester, Great Britain

Mr. Erkki Pesonen
Managing Director
Kansa Mutual Insurance Companies
Helsinki, Finland

Mr. Ferdinand Goppold
Executive Officer
Volksfürsorge Insurance
Companies Group
Hamburg, Germany

Mr. Henri Rijkers
Actuary-Manager
La Prévoyance Sociale
Brussels, Belgium

Dr. John Hogan
Vice President--Planning &
Development
Nationwide Insurance Companies
Columbus, Ohio, U.S.A.

Mr. Robert E. Vanderbeek
President
League Insurance Group
Detroit, Michigan, U.S.A.
Commission Chairman

Mr. Yuji Ishihara, Manager
Product Development Department
Zenkyoren
Tokyo, Japan

Also participating in the study were:

Mr. Craig Ansley, F.I.A.
Teaching Fellow
University of Michigan
Ann Arbor, Michigan, U.S.A.

Mrs. Traute Klatte
Executive Secretary for
International Affairs
Volksfürsorge Insurance
Companies Group

Dr. Dennis Reimuth
Director of Special Projects
League Insurance Group

PREFACE

In 1972 the International Cooperative Insurance Federation (ICIF) established an "Investment of Funds Commission." Their report was discussed at the October, 1974, ICIF Conference in Tokyo, Japan. The first paragraph of their report is as follows:

"The worldwide context of inflation has posed a challenge to all persons interested in life insurance. The carefully laid and faithfully financed plans of insureds are disrupted when the purchasing power of policy benefits diminishes. Beneficiaries receive benefits which, in terms of purchasing power, are reduced. The economy experiences decreased capital as the savings flow through life insurance companies increases at a diminishing rate."

Their report outlined various investment approaches that could be taken to lessen the impact of inflation. The introduction of their report concludes with the following statement:

"The report invites member companies to choose from the many concepts, practices, and contracts described with a view to whatever is good for their policyholders, and appropriate and practical under their national conditions of supervision, taxation, and market circumstances.

"The Commission would like to remind that the new contract forms, however ingenious, will not restore the historical role of life insurance saving unless they are combined with equally ingenious methods of marketing, influencing government policies, and communication with the consumer."

In Tokyo, the Executive Committee of the ICIF agreed to establish a new commission--the "Commission on Inflation and Insurance." It was not the purpose of the new Commission to examine the causes of worldwide inflation, but rather to concentrate on what life and non-life insurers are doing and can do to lessen the problems inflation causes insurers and policyholders.

The new Commission met in London in May, 1975, and in Washington, D.C., in November, 1975. In addition, each member was assigned an area of responsibility and did extensive research before and after each meeting.

As you read the report of the Commission on Inflation and Insurance, please keep in mind the points made in the concluding remarks of the Investment of Funds Commission. Conditions vary from country to country, and we recognize that the recommendations would not be practical in all countries. It is also recognized that the report contains some recommendations, like those having to do with indexing, that could be considered inflationary rather than deflationary.

Our report includes in Section I a Summary and Recommendations. However, it is hoped that member companies will have an opportunity to review the full report and examine the various appendices so that the Commission recommendations can be better understood.

The language style of the report is "American" English. We have included a Glossary of terms that, hopefully, will be of assistance to those readers who are not accustomed to American English.

The Chairman would like to express his thanks to the Commission members and others who participated in the work of the Commission for their dedication and cooperation. The Chairman would also like to express particular thanks to Dr. Reimuth, who had the major responsibility in assembling and editing the report, to Ginny Stanaway, for typing report drafts, and to Lorraine Smith for assistance on meeting planning, correspondence, and preparation of the final report.

December, 1975


Chairman

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Section I

SUMMARY AND RECOMMENDATIONS

We have detailed in this report some of the attempts of insurers around the world to cope with inflation in the areas of products, investments, loss prevention and expense control. Our report emphasizes the need for new ideas to meet inflation problems of both insurers and policyholders. Some recommendations may appear to be unconventional and we recognize that the implementation of some of our suggestions may not be possible in all countries. But, it is our strong conviction that new approaches by insurers, and also by regulatory authorities, are required to meet the serious problems that inflation is causing policyholders and insurers. Cooperative insurers have a special obligation and opportunity to adopt new solutions because of their unique relationship to their policyholders, sponsoring organizations, and government. We therefore urge that cooperative insurers carefully review our recommendations to make a proper determination as to which recommendations are of value to their own society and their policyholders.

For completeness we include in this section a summary of the matters which are dealt with more fully in the full report.

PROBLEMS OF INFLATION AND LIFE INSURANCE

Life insurance policyholders face the serious problem of the declining real value of life insurance benefits from time to time as a result of inflation.

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and Insurance
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Annuitants and pensioners are particularly vulnerable to inflation because usually their income is fixed at the outset in terms of the currency in which the contract is issued. The impact on the life insurer is that administration expenses increase and premium loadings can become inadequate. Life insurers will also experience a significant outflow of funds if large numbers of policyholders surrender their contracts on terms which cannot be varied, and a much smaller growth of funds if policyholders abandon savings contracts in favor of term insurance because of inflation. In almost all countries, the investment requirements of yield, liquidity, and safety have proved incompatible.

PROBLEMS OF INFLATION AND NON-LIFE INSURANCE

During periods of inflation non-life policyholders face the problem of maintaining adequate insurance to value on their insured property. If they are underinsured and there is a coinsurance, or average, clause they may not realize that if they suffer a loss the insurers will only meet the proportion of the loss that their amount of insurance bears to the full value of their property. From the viewpoint of the non-life insurer, the failure of policyholders to maintain insurance to value produces premium inadequacies.

Non-life insurers, particularly those writing third-party liability insurance, may suffer severe underwriting losses when the rate of inflation rises rapidly because of the time lag involved in adjusting premium rates

both for new and existing business to take into account the inflated claims and expenses already experienced and those anticipated in the future. Reinsurers face an even greater problem in nonproportional reinsurance because of the lag in the payment of large claims. The governmental regulation of non-life rates in many countries adds to the time lag problem.

The occurrence of underwriting losses or at best the dramatic reduction in underwriting profits which have resulted from inflation and the devaluation of assets which occurred in many countries in the last two years have seriously eroded the surplus of many companies. The effect is to limit non-life insurers' underwriting capacity and may even affect solvency.

Inflation also affects the operations of fixed deductibles in non-life insurance. Loss and expense costs to insurers increase disproportionately under such arrangements.

RECOMMENDATIONS

Life Insurance Product Innovation

One of the major responses of life insurers to inflation in many countries has been the development of equity-type or variable life and annuity policies. In our opinion, such policies have not effectively solved the inflation problem either for the policyholder or for the insurer.

We recommend that cooperative insurers consider issuing indexed term life insurance policies. Under such policies, benefits and premiums are linked to some type of cost-of-living index. They offer advantages to the policyholder and insurer under inflationary conditions. Such policies are being successfully marketed in some countries. Since there are little or no actuarial reserves, few significant technical problems exist. Adverse selection problems can be reduced or eliminated by limiting or restricting the options of the policyholder. (See text for a further discussion.)

We also recommend indexed permanent insurance for meeting inflation problems. We recognize the difficulties of applying indexation because inflation-related investment opportunities differ by country and the potential difficulty of insurers to explain indexed permanent insurance to policyholders. Indexation of permanent life insurance is, in effect, another method of distributing profits (surplus). "Conditional" and partial indexing may be the most promising method (see text). We believe that the further development of this concept would be in the interest of both cooperative insurers and their policyholders.

Non-Life Insurance Product Innovation

We recommend the extension of indexation to non-life insurance branches where claim amounts are directly related to increasing indices

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(for instance, compulsory third-party automobile liability insurance).

Indexation of premiums offers many advantages to the insurer and can reduce the areas of controversy between insurers and regulatory authorities.

The linkage of premiums and insured amounts is being accomplished in homeowners insurance in many countries. Such indexing solves the problem of underinsurance and has proved very practical with few problems. We believe indexation is preferable to the use of the average or coinsurance clause.

The Swedish approach of unlimited fire insurance coverage with premiums adjustable annually is an interesting alternative. We recommend further study of this development.

The development of indexation of the fire reinstatement clause for industrial risks in Norway and the United Kingdom is an innovation benefiting policyholders. We recommend the possibility of extending this concept to homeowners insurance.

Stability or index clauses in nonproportional reinsurance contracts have not been applied in every country for competitive reasons. We believe that stability clauses lead to greater equity between primary insurers and reinsurers.

Investments

The insurer's problem of erosion of capital value by inflation can be

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lessened either by reappraisal of investment policy using present opportunities or by introduction of new investment possibilities.

In the long term, some presently available investment opportunities, notably equity stocks and property, have kept pace with inflation, but in the short run none has satisfied the requirements of both liquidity and capital safety. The possibility of maintaining liquidity without having to sell investments at a loss because of temporary cash flow problems received considerable attention. Two ideas are suggested:

1. Introduction of industry stabilization reserve funds
designed to meet individual company cash flow needs
in the short run
2. Obtaining private banking lending facilities or a government lending facility of last resort

We strongly recommend that these investment possibilities be further
researched.

We also recommend that cooperative companies work to obtain intro-
duction of indexed securities. Individual insurers should lead the effort by attempting to index direct loans such as home purchase loans.

Also, indexing of policy loans should be introduced in line with indexation of other investments. Insurers should also encourage other private institutions to issue indexed securities. If private indexing proves not to be feasible or inadequate in a particular country, then government

issue of indexed securities is recommended.

In some countries the investment flexibility of insurers is restricted by statute or regulatory authorities. Also, in some countries policy loan rates are fixed by the terms of the policy and required by law. Cooperative insurers should also seek to change legal restrictions limiting the investment and loan rate flexibility.

Loss Prevention and Expense Control

The two basic elements of the premium are claims and expenses. Both elements are heavily influenced by inflation. Efforts to reduce the costs of both elements through loss prevention and other expense control techniques become extremely important objectives.

In the automobile claims area, insurers in some countries are:

1. conducting research to improve techniques of repairing motor vehicles
2. supervising claim costs by using careful inspection techniques
3. establishing car repair centers either on an individual or joint basis with the insurance industry
4. establishing rating structures based on repairability with the objective of reducing the cost of motor vehicle parts

We recommend that these important loss control developments be extended wherever possible.

We recommend that cooperative insurers make every effort to increase productivity and reduce expenses by:

1. improved administrative procedures including the increased use of electronic data processing systems
2. improved marketing approaches that will lower sales costs

We believe that collective insurance has a potential of reducing marketing and administrative costs. Examples are group automobile insurance written as an employee benefit and collective homeowners insurance programs such as that written in Norway. Cooperative insurers should renew and/or initiate efforts to introduce, or expand, collective insurance plans.

We also believe that the elimination of the fault factor, currently so prominent in the third-party liability system for automobile and other types of accidents, can produce significant expense savings as well as introducing more efficiency and equity in the compensation system.

COOPERATIVE ACTIONS

Some countries have made special internal and external efforts to combat inflation. Japan offers a very useful example of the recent positive actions taken by insurers and government in meeting serious inflation problems. Life and non-life insurers in Japan responded swiftly by introducing measures to

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reduce expenses and offering new inflation-related policies.

We recommend that cooperative insurers in every country make renewed efforts to: (1) inform their policyholders and to influence related organizations and government on the problems of inflation; (2) implement new inflation-related products; and (3) seek remedial legislation where necessary.

Section II

INTRODUCTION

Inflation is said to exist when there is a rise in the general level of the prices of goods and services. Extremely high rates of inflation are generally referred to as "hyper-inflation" or "run-away" inflation, and low rates of inflation are referred to as "creeping" inflation. There are no precise definitions of these terms. An historical example of the effect of hyper-inflation on the social fabric of a country could be seen in the German experience in the 1920's (see Appendix II). Table 1 of Appendix I gives a comparison of the index of inflation for 16 selected industrial countries for the period 1961-71 and for years 1971 to 1974 with estimated rates for 1975, and Table A summarizes the information.¹

IMPACT OF INFLATION ON LIFE INSURANCE POLICYHOLDERS

The major problem faced by the life insurance policyholder in an inflationary economy is the declining "real" value of a fixed benefit. The real return on premiums paid may be extremely low or even negative. As discussed in Appendix II the extreme example is Germany where a fixed amount of 25,000 marks in 1918 could have purchased a house, but by 1923 the same number of marks could not have purchased even a postage

¹Table 2 of Appendix I compares the average annual inflation rates of the periods 1966-70 and 1970-74 for countries around the world.

Table A
Distribution of Inflation Rates for 16 Countries*

Average Annual Inflation Rate	Number of Countries					
	Period 1961-1970	Years				
		1971	1972	1973	1974	1975
Up to 3%	4	2				
3.1 - 5%	8	3	3			
5.1 - 7.5%	11	10	11	7	1	2
7.6 - 10%		1	2	5	2	2
10.1 - 15%	1			3	6	8
15.1 - 20%					4	2
Over 20%				1	2	2

*Inflation rate = % change in consumer prices.

Countries included in investigation:

West Germany	Italy	Canada	Denmark
Belgium	Japan	Finland	Iceland
United States	Netherlands	Sweden	Australia
France	U. K.	Norway	Switzerland

Source: OECD Main Economic Indicators

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stamp. The policyholder can attempt to increase his insurance in real terms, as inflation erodes the face amount of his contract. As his age increases, the premium rate will also increase and he has to face the possibility that he may be uninsurable. Group life insurance offers some relief if it is wage related, but some insurance needs may continue beyond the period of employment when group life coverage may have ceased.

While inflation decreases the real value of life insurance death benefits considerably, its effect may be catastrophic to policyholders receiving fixed annuity or pension benefits. Retirees with fixed pensions are particularly vulnerable since they have little or no opportunity to increase current income. Insureds receiving fixed disability incomes are in a similar position.

IMPACT OF INFLATION ON POLICYHOLDERS IN NON-LIFE INSURANCE

In non-life insurance the problems created by inflation for the insured differ from life insurance problems because benefits are on an indemnity basis rather than on a fixed-amount basis. Premiums inevitably increase and may become so high that the policyholders whose incomes have not kept pace with the increases either relinquish their policies or continue them on a reduced basis in real terms. In fire and homeowners insurance, the insured who fails to increase his policy face amounts according to the increase in the values of his property faces a large risk that the insurance will be inadequate if a total loss occurs. In the case of a partial loss, he may be

penalized financially by the operation of a coinsurance or proportional clause. The potential increase in building costs from the time of the loss to the time of replacement of the property is an additional risk.

For those who are injured in automobile accidents and who look for compensation under the liability insurance system, inflation has two effects. First, those who are in the process of settlement may settle early for inadequate amounts because of immediate financial problems caused by the rise in the cost of living. Secondly, those who have received a settlement in the past find it inadequate as time passes and the cost of living continues to rise.

IMPACT OF INFLATION ON COOPERATIVE INSURANCE COMPANIES

The fortunes of cooperative insurance companies are closely linked to those of their policyholders, but the problems an insurer faces in an inflationary economy are not identical to those of its insureds. Most of the problems are related to the nature of the insurance business. As a "service" the insurance product depends more on wage levels than on price levels, both in administration expenses and, in non-life insurance, the loss or claim component. Thus, the "cost-of-living index" may not be a particularly adequate measure of inflation problems from the perspective of the insurer. In addition, inflationary problems differ somewhat for life and non-life insurance.

Inflation Problems of Life Insurers:

One major problem faced by life insurance companies is the escalation of expenses caused by inflation in servicing individual fixed-premium long-term policies. Expense loadings which are fixed at the time of issuance can become seriously inadequate. When the inflation rate is volatile, it becomes extremely difficult to forecast inflation and include an adequate allowance for expenses in the premium structure. Increased sales of new policies in an inflationary period, leading to increased expense allowance per policy, may not be sufficient to cover the increase in expenses. And even if growth of insurance volume is sufficient to cover such expenses, the result is that newer policyholders carry too high a proportion of the costs and subsidize policyholders who hold older contracts.

A second major problem that life insurers face under conditions of inflation is the investment of reserve and surplus funds. Because individual life insurance contracts are long-term commitments, life companies invest in long-term, secure investments. If inflation is moderate, the earnings on investments are usually sufficient to produce positive real returns, at least equal to the nominal rate of interest assumed in reserves; and, other things being equal, the valuation of assets and liabilities will not disclose a deficiency. However, if investment earnings produce negative real returns, as is the case in a highly inflationary period, the impact may be financially disastrous because the real value of the benefits have eroded

before the claim is made. Policyholders cancel individual contracts with savings features and/or a high proportion of policyholders borrow loan values resulting in significant cash flows out of the company. Policyholders may also shift to term insurance contracts resulting in less premium income to the insurer, or sales of new life insurance may actually decline. Some of the foregoing consequences were experienced by life insurers in many countries, particularly in 1973 and 1974. Also adding to the investment dilemma are those governments who require investment by insurers in "socially desirable" programs where the returns may be relatively low.

Another problem emerging in some countries is a government requirement that pensions and annuities must be linked to a cost-of-living index. While such requirements may be socially desirable, index-linked investment media of funding from government sources must be provided or fulfillment of such contracts may be impossible.

Inflation Problems of Non-Life Insurers

Non-life insurers face a different set of problems created by inflation. Even though premiums can be adjusted periodically, there is a considerable time lag between the inflated claim and expense experience and the reflection of the higher costs in new premiums. When inflation is escalating, the lag problem is severe. Indeed, the past loss and expense experience in an inflationary period may be irrelevant. As in life insurance, the costs

incurred by non-life insurers are largely wage-related. Labor costs also are a significant component in the claims that non-life insurers pay.

A study by Munich Reinsurance Company in 1971 estimated the breakdown of costs incurred by non-life insurers in Germany. Table B is taken from that study.

Table B

A Breakdown of the Expenditure Incurred
By Non-Life Insurance Companies

	<u>Depending on</u> <u>Labor Costs</u>	<u>Depending</u> <u>on Prices</u>	<u>Other</u> <u>Influences</u>	<u>Not Subject</u> <u>to Cost-</u> <u>Increasing</u> <u>Influences</u>
Claims	approx. 50 %	approx. 25 - 30 %	approx. 10 - 20 %	approx. 8 - 10 %
Expenses	approx. 60 - 65 %	approx. 20 %	-	approx. 15 - 20 %
Total Expenditure	approx. 52 - 55 %	approx. 23 - 27 %	approx. 6 - 12 %	approx. 10 - 14 %

Source: "The Influence of Inflation on Insurance,"
(Published by Munich Reinsurance Co., May, 1971), p. 12.

Although the figures in the table may vary from company to company and with the composition of a particular company's book of business, the table reveals that approximately 50 percent of the claim component is dependent on labor costs and 25-30 percent is dependent on prices, e.g., prices of parts and materials (which also are partially composed of labor costs). Since

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wages tend to increase even in the absence of an increase in the cost-of-living index, insurance companies face a constant inflationary bias.

Another inflationary factor, sometimes referred to as "superimposed" inflation, may also exist in certain lines of non-life insurance, particularly liability insurance. This factor is also reflected in Table B and labeled as "Other Influences." An example of this factor is the improvement in the quality of medical practices and treatment leading to increased longevity of accident victims which tends to increase claim costs over time. Another example is the tendency of courts to award more liberal amounts for general damages or "pain and suffering" in liability actions. The foregoing examples are frequently cited to explain the discrepancy between the higher average claim cost of bodily injury liability experienced by insurers and other indices measuring cost-of-living and wage and salary increases.

The last column of Table B, labeled "Not Subject to Cost-Increasing Influences," refers to those insurance lines in which the loss payable is a fixed sum, e.g., personal accident insurance, as opposed to insurance based on the principle of indemnity. From the insurer's point of view, the claim amounts are not influenced by inflation when the loss payable is fixed.

Relatively high and/or fluctuating rates of inflation create special problems for non-life insurers. In liability insurance lines, such as automobile bodily injury liability, there is an inherent delay in the settlement of claims which can result in serious financial problems when the inflation

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rate increases substantially. Premiums which were established on the basis of projected losses based on a past period maybe inadequate to meet the losses at the time of settlement. Table C illustrates the impact of inflation when claim settlements are delayed. Table C estimates the percentage increases in the final claim costs at varying inflation rates with varying average delay of settlements. For example, the table indicates that an increase in the inflation rate of 4 percent with an average delay of settlement of three years will result in an increase of 14 percent in the final claim costs.

Table C

Average Delay of Settlement

<u>Increased Degree of Claims Inflation</u>	<u>1 Year</u>	<u>1.5 Years</u>	<u>2 Years</u>	<u>2.5 Years</u>	<u>3 Years</u>	<u>4 Years</u>
2 %	2	3	4	5	6	9
4 %	4	6	9	11	14	19
6 %	6	10	14	18	22	32
8 %	9	14	19	25	32	47

Source: Gunnar Benktander, "Inflation and Insurance: Measuring the Problem and Facing It," "Reinsurance" (Vol. 6, No. 12, April, 1975), p. 601

Similarly, loss reserves may become seriously inadequate when the rate of inflation increases. The problem of reserving for large losses where

settlements are delayed is particularly severe if the inflation factor used in reserving is inadequate or impossible to predict. If investment returns do not offset the inflation of losses, the surplus of the company may be reduced. Insurers in many countries in 1974 experienced a substantial reduction in surplus as a result of the combination of "underwriting losses" largely produced by high rates of inflation, plus a simultaneous loss in the value of securities held.² Some insurers saw their solvency margin threatened.

A special problem of insurers writing fire and homeowners insurance is the tendency of policyholders in a time of inflation to fail to update the insurance amounts equal to the increasing value of their property. Since insurers tend to pay partial losses in full, even if there is an average or coinsurance clause, the financial effect is that premiums become inadequate. That is, if insureds do not insure for a relatively high percentage to the value of their property based on the policy maximum insured, premiums become inadequate since the preponderance of losses are partial. To relieve this problem insurers in many countries now link the insurance amounts of fire and homeowners insurance to some type of price index. This topic will be discussed in Section IV.

²See Table 1 of Appendix III for a comparison of stock market indices of selected countries.

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A related problem in non-life insurance, and particularly in automobile collision insurance, is the effect of inflation on deductibles. Fixed-amount deductibles are cost raising to the insurer under inflationary conditions since: (1) more claims exceed the fixed-deductible amount, and are therefore payable; and (2) expenses are incurred for handling a larger number of small claims. The overall effect is to increase the average claim costs and expenses of adjusting and handling such losses. To the extent premiums do not anticipate such an increase, the insurer suffers losses.

Section III

INFLATION AND PRODUCT INNOVATION

Insurance companies in the past, as well as currently, are attempting to meet the problems of inflation by various means. Innovations have been introduced by insurers in the nature of the products sold and in pricing mechanisms. Some of these innovations have been successful while others have failed. In some instances, failure was due to external reasons, e.g., governmental action or prohibition, while in other cases policyholders did not accept a particular innovation.

The Commission devoted considerable attention to the area of "indexing" or "index-linking." Index-linking represents a useful technique since it automatically relates either insurance benefits and/or price to some objective measure or "index" of inflation. The Commission has examined indexing as a method of living with inflation and as a tool of protecting policyholders as well as insurers from the distortions inflation causes.³ Index-linkage of insurance has, in fact, been successful in some areas, especially in non-life insurance and several governments have used the technique in social insurance programs.

Index-linkage techniques differ between life and non-life insurance.

³Brazil adopted a widespread indexation system of financial instruments in the 1960's and the relatively high rate of inflation was eventually lowered significantly. However, it has also been argued that Brazil is not a general model since: (1) it is a developing country; (2) indexation in Brazil was introduced by a military regime; and (3) indexing worsened the distribution of income in Brazil.

Moreover, in life insurance and pensions with a savings element, the feasibility of index-linkage is related to the availability of inflation-proofed investments. The investment problem is discussed in a separate section.

LIFE INSURANCE PRODUCT INNOVATION

Indexed Term Insurance

Indexed term insurance contracts have been successfully marketed in some countries. Under such contracts both the premiums and the amounts of insurance are commonly linked to an index--usually a cost-of-living index. That is, the increases in benefits required by the index are completely financed by increased premiums. Since there are little or no actuarial reserves, no investment problems are presented.

Indexed term policies were introduced in Finland as early as in the 1940's. In Iceland--which has experienced high inflation rates--endowment life insurance has practically disappeared and companies now sell fully indexed term insurance.

In the United Kingdom, Legal and General Insurance Company has developed a "Family Income Plan" which is essentially an indexed, decreasing term insurance policy. Under this contract both the premium and the insurance amounts are tied with the cost-of-living index during the lifetime of the insured. At the death of the insured (within the term) the beneficiary receives a yearly income starting at an indexed amount and increasing by 10 percent per annum. For a fuller description of the

policy, see Appendix IV.

In the United States some companies have also introduced innovations in indexed term insurance. League Life Insurance Company of Michigan recently developed a low-cost "Family Group Life" policy with coverage on all family members in which the term insurance amounts and premiums are fully tied to a cost-of-living index.

Other companies have also applied the technique in different forms. Indexed term insurance may be combined with permanent insurance. For instance, term insurance riders equal to indexed increases in the face amount can be attached to policies with a savings element. Alternatively, options can be provided to take dividends or profit distributions in the form of term insurance riders. For example, Teachers Insurance and Annuity Association of New York has successfully marketed a one-year term addition tied to the cost-of-living index on all of its individual policies.

The advantage of such contracts to the policyholder is that additional amounts of insurance are added automatically and without evidence of insurability or good health. Such contracts also greatly reduce the problem of rising administration expenses of the insurer in an inflationary period since premium income automatically increases. The major disadvantages to the policyholder are: (1) the temporary nature of term insurance; and (2) dual increases in premium payments for both increasing age and cost of living may become a financial burden.

The insurer must develop techniques to minimize adverse selection so as to assure that the insurance is economically feasible. For example, under the indexed Family Group Life policy issued by League Life Insurance Company, and insuring about 500,000 people, indexed increases in premiums and benefits automatically apply to all policies. The policy contains an option allowing a policyholder to convert to an identical policy without the "index feature." Once having elected the option, he is ineligible for future cost-of-living benefit increases. Benefits and premiums were recently increased 20 percent. Policyholders were strongly urged to maintain their indexed policy, and fewer than one-half of one percent of the policyholders exercised the conversion option (see Appendix V).

Indexing of Permanent Insurance

Indexing of permanent insurance creates some special problems of financing primarily due to the large policy reserves involved. Any increase in the face amount of a life policy must be financed by either:

- (a) an increase in premium, or
- (b) appropriation of surplus funds, or
- (c) some combination of these two

Surplus funds are at present often used to increase the face value and thus provide some offset to inflation. In Europe, for example, surplus is used to provide "reversionary bonuses" or paid-up additions to the face value. U.S. insurer practice is to distribute surplus as dividends, which can often be

applied to purchase paid-up additions to the face value in the same way.

Unfortunately, additions to the face value financed by surplus generally fall far short of providing protection against inflation. Neither can indexed premiums finance indexed face values without using surplus appropriations as well. In fact, to operate on a completely sound financial basis, indexation of the face values and premiums must be supported by investments which fully maintain their real value in times of inflation.

The consequences of the three approaches to financing indexation can be compared by examining the simplified formula for policy reserves in life insurance (for simplicity expenses and other considerations have been deleted):

$$\begin{aligned}\text{Policy reserve} &= \text{present value of face amount} \\ &\quad - \text{present value of premiums.}\end{aligned}$$

To take an example, suppose that for a particular policy:

$$\begin{aligned}\text{Present value of face amount} &= \$10,000 \\ \text{Present value of premiums} &= \$4,000 \\ \text{Policy reserve} &= \$10,000 - \$4,000 = \$6,000\end{aligned}$$

Following this example through, suppose that there was an inflation rate of 10 percent during the year. The effects of the three methods of financing the required 10 percent increase can now be examined.

Financing by Premium Increases Alone. In this example, index-linkage requires a 10 percent increase in face amount. The present value of the

face amount is therefore also increased by 10 percent, that is, by \$1,000.

Under this method, no surplus will be used to finance the increase. Therefore, premiums must be raised to provide the additional \$1,000 of present value. This requires an increase of $1000/4000$ or 25 percent.

In practice, premiums increase at a greater rate than the face value because the increases are purchased by the policyholder at an older age than when the policy was originally written. This effect will, in fact, worsen over the term of the policy as the reserve grows and the effect of advancing age becomes more pronounced.

Increases Financed by Surplus Funds. Returning to the example, suppose that the funds supporting the policy amounted to \$6,600, leaving a surplus of \$600. If the premium were left fixed and the surplus of \$600 were appropriated to provide an increased face amount, the face amount could be increased to the point where the new policy reserve was \$6,600, or the total accumulated reserve fund. The value of the new face amount is therefore:

$$\begin{aligned}
 \text{Value of increased face amount} &= \text{Total accumulated reserve fund} \\
 &\quad + \text{present value of premiums} \\
 &= \$6,600 + \$4,000 \\
 &= \$10,600
 \end{aligned}$$

The face amount can therefore be increased by $600/10,000$ or 6 percent without increasing the premiums. This falls well short of the required

10 percent increase, even though the surplus was about 10 percent of the fund. In other words, even if the real rate of return (i.e., the rate after inflation) is as high as the interest rate assumed in the reserve calculations, the resulting surplus will not provide increases to match inflation.

Indexation of Both Face Amount and Premiums. Using the same example, suppose that both the face amount and premiums are increased by the inflation rate of 10 percent.

Present value of increased face amount = $1.1 \times \$10,000 = \$11,000$

Present value of increased premiums = $1.1 \times \$4,000 = \$4,400$

New policy reserve = present value of increased face amount

- present value of increased premiums

= $\$11,000 - \$4,400$

= $\$6,600$

In the example, the total accumulated reserve fund was \$6,600, so that a combination of surplus funds plus indexed premiums is sufficient to finance the indexed face amount.

The 10 percent surplus figure is no accident. In general, it would be necessary to earn surplus investment yield at the same rate as inflation to maintain an indexing scheme. In other words, investments must retain their real value and, in addition, provide the nominal rate assumed in the reserve calculations.

In practice, several other points are important. First, surplus may result

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from favorable mortality or expense savings as well as from investment yield. Mortality rates have been generally decreasing for many years, and this is therefore a realistic source of surplus. Expenses will, of course, increase with inflation, but, if the gross premium is indexed, the expense loading will increase proportionately. By using modern technology and cost-saving methods, it may be possible to hold increases in expenses to less than the increases in the inflation index being used for indexation.

Second, gross premiums usually include a loading for initial expenses and commissions, which are paid in "old" currency at the outset. Any index-linked increase in gross premium will therefore contain a redundant increase in this loading, which can be used to offset the cost of indexation.

Third, it may be possible to calculate premiums on an artificially low interest rate to ensure a strong emergence of surplus in the future. For example, the premiums might be calculated on a 4 percent interest basis and, in addition, allow for 10 percent annual increases in both premiums and face amount. This would mean that an effective interest rate of minus 6 percent would be used. This is an extreme example; a less severe loading might well be adequate.

It should be noted, however, that the inflation problem is not entirely solved by this approach unless the investments are fully hedged against inflation. Otherwise surplus premiums must be accumulated to help finance future increases, so that to a certain extent old money will still be used to meet inflated benefits. Nevertheless, with good investment yields, and

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possibly moderate premium loadings, indexing may still be an attractive compromise to both company and policyholder.

Finally, there is the possibility of partial index-linking. Under this scheme, premiums and face amounts could be increased by, say, 50 percent of the current inflation rate to provide partial protection against inflation. The level of surplus need not be so high in this case.

Indexed permanent policies are currently being issued in Finland. The system can be described as a "conditional and partial" indexing system. Until the latter part of the 1960's, companies in Finland issued policies with a guarantee of 50 percent index-linkage, and voluntarily paid through profit-sharing up to 100 percent during the first policy years. This index-linking was aided by the opportunity to invest in indexed securities. However, index loans have since been prohibited by law, and indexation is no longer guaranteed. Despite these changes, companies still attempt to maintain 100 percent indexing for newer policies and 50 percent indexed coverage for older policies.

Another country where indexed permanent life policies have a long tradition is Israel. Indexation in Israel began in 1958 based on the fact that insurers have the opportunity of investing the policy reserves in indexed state bonds. Life insurers in Chile have also employed such indexation where indexed securities are available.

Equity (Variable) Life Insurance Products

Another class of "inflation-related" insurance contracts which has been introduced in some countries is "variable" benefit life insurance or annuities.⁴ Under a variety of contracts benefits and/or premiums are linked to specific investment portfolios generally consisting of stock or equity investments. The assumption that the investment portfolio underlying the benefits will be closely related to the rate of inflation has proved to be tenuous--at least over the short run. The recent experience in many countries under such contracts in which stock values fell precipitously with a simultaneous increase in the rates of inflation represented the worst possible combination for such contracts. Since the entire investment risk falls upon the policyholder under variable contracts, serious marketing and public relations problems present themselves to the company when portfolio values decline substantially.

Other Life Products

Another product innovation recently developed in the United States by

⁴For a comprehensive study of the development of equity and variable life insurance around the world, see "Report of the Investment of Funds Commission," presented to the I.C.I.F. meeting in October, 1974, in Tokyo, Japan.

Minnesota Mutual Life combines term and whole life insurance with the insured possessing the ability to change the mix of the two, and the opportunity to increase the amount of insurance according to the cost of living. The face amount and/or the premium can be either increased or decreased on the premium due date.

Although an increase in the face amount requires evidence of insurability, under an option the amount is automatically increased without evidence (unless the entire option is rejected by the insured) according to changes in the cost-of-living index every third year. However, the amount of the increase is limited to a maximum of 20 percent increase in the Consumer Price Index for the most recent three-year period and a maximum of \$20,000 at any one time. When either the insured amount or the premium or both are adjusted, the corresponding new plan is determined by computer. The plan of insurance, which can be changed at any premium due date, must lie in a range from coverage for five years (essentially five-year term insurance) to coverage for life with premium payable for at least five years. Within this range the insured has complete flexibility to change the plan. See Appendix VI for more details of the policy.

Apparently the policy has enjoyed moderate success. Although the policy gives the insured considerable flexibility to change according to his insurance needs and income available for premiums, the primary disadvantage appears to be its complexity. It may be quite difficult to explain to the policyholder, and thus be difficult to market.

Private Pensions and Annuities

Where pensions are government funded, benefits are quite commonly protected by index-linkage, at least to a certain extent. In "fixed" government pension systems periodic upward adjustments in benefits for retirees are usually made to allow for inflation. In private pensions, however, the indexation problem is two-phased. The first is the problem of financing the increasing value of the pension benefit before retirement age. In many pension schemes the amount of the pension is dependent on the final salary which is a form of automatic index-linkage. This problem is generally solved by increasing premiums, although, again, maintenance of the real value of invested reserves is a problem. The second, more serious problem, is the financing of index-linked pension benefits for retirees. In some countries, employers have dealt with this problem by making extra payments to the pension plan to increase the benefits for retirees.

In Sweden, employment pensions are administered by insurance companies and pension benefits after retirement are linked to the cost of living. The increases have been financed by surplus generated within the plan. Pensioners have received benefits in past years equal to the cost-of-living increases. It should be noted that Sweden's inflation rate has been relatively moderate.

In Finland, compulsory employment pensions are tied to the wage index. Index increases are financed by increasing future premiums.

As in private indexed life insurance, the primary difficulty with fully indexed private pensions is the problem of investing assets to finance the cost-of-living increases. The investment problem is discussed in Section III.

A NOTE ON TAXATION

Mention should be made of the importance of government taxation of insurance. Taxation is an extremely important factor in life insurance, both from the point of view of the policyholder and the insurer, and is very relevant in an inflationary period. Taxation is a complex subject and varies considerably by country. In some countries, governments have provided tax incentives and advantages to encourage savings and the purchase of life insurance. The Commission has not had the opportunity of analyzing this area. However, League Life Insurance Company has commissioned a study on this subject. Hopefully, the study will be completed by the summer of 1976.

NON-LIFE INSURANCE PRODUCT INNOVATIONS

Fire and Homeowners Insurance

As previously mentioned, the use of indexation in non-life insurance differs from life insurance with a savings feature since the investment function is not a factor. Two techniques to meet the problem of under-

insurance and/or adequate pricing for fire and homeowners insurance in an inflationary economy have been developed. The most common form is the indexation of the insured amount--the policy limits are automatically adjusted according to some type of building cost index. Such indexing has been employed by insurers in many countries for many years, e.g., Germany, United Kingdom, and other European countries. Indexed fire and homeowners contracts have just begun to appear in the United States and Japan.

An alternative approach is one recently developed in Sweden. Companies in Sweden have ceased to use the amount of fire insurance on buildings. Rather, coverage is essentially unlimited to the policyholder and premiums are adjusted annually. The Swedish approach is superior since the policyholder is always assured of adequate coverage. However, rating becomes somewhat complex and there can also be some reinsurance problems under this approach.

A very interesting development is one introduced in the United Kingdom and Norway. Indexing has been extended by companies in these countries in the reinstatement clause for industrial risks after the occurrence of a fire loss. Such provisions protect the policyholder from the risk of rising building costs occurring after the loss.

Liability Insurance

Third-party liability insurance presents a different set of problems with

respect to the possibility of indexing. Neither the investment function or the benefits are directly related to premiums. The exceptions with respect to benefits are some European countries in which seriously injured third-party victims currently receive indexed pensions. For example, in Sweden, auto accident pensions for serious accident cases are indexed subject to a 5 per cent per annum increase. Recently, the same system was extended in Sweden to include other voluntary liability insurance. In Finland, compulsory third-party liability auto insurance pensions have long been indexed. These indexed benefits have been financed by special extra premiums rather than by indexed premiums. A similar precedent has been established in Michigan in the United States. First-party no-fault income benefit limits under the Michigan No-Fault Law are linked to the cost-of-living index. No specific provision for indexing of premiums is provided. However, the adjustment of the limits is not retrospective (i.e., adjustments do not apply to accidents occurring prior to any upward adjustment). Indexed income or pension benefits for injured victims are obviously a benefit from the injured's point of view.

Belgium and Denmark are countries where insurers have been allowed to link third-party auto liability premiums to an index. The advantage of indexing premiums to the insurer is clear since it permits quicker and automatic adjustment of premiums, particularly when the rate of inflation is increasing as in recent years.

Automobile insurance rates are heavily regulated by government in almost every country in the world. Regulatory authorities in many countries are under intense pressure to either reject rate increase requests by insurers, or to allow minimal, but not adequate, rate increases. The administrative procedure and delay in the rate regulation process may in itself result in further adverse financial consequences, particularly when the inflation rate is increasing. There is also an inherent time lag in implementing new rates for all policyholders if the dates of renewal are staggered.

Increasing premiums with no corresponding increase in the policy limits may be difficult to explain to the policyholder. But it can hardly be denied that inflation is an extremely important variable in claims as well as in the expenses of the insurer. It is not the only factor since frequency of claims is also relevant. But, if claim frequency is relatively stable over long periods of time, indexing liability premiums is a valuable tool. Certainly, indexing would narrow the ground for dispute between insurers and the regulatory authorities.

Indexation involves technical questions. The selection of a proper and accurate index is an important problem. Belgian automobile insurers currently link third-party automobile insurance premiums to the cost-of-living index, but effort is currently being made to devise a more suitable

Index.⁵

The data included in an index and the application of the index to premiums may also be outdated if inflation rates are increasing. Practical problems involving indexation include the question of how frequently the index should be applied to premiums, e.g., annually, at renewal dates, or during the term of the policy. Furthermore, indexation would probably have to be universally applied by all companies if there is a competitive insurance market. But, given the current high inflation rates and the increasing variability of inflation, such problems must be overcome.

Deductibles

Deductibles in first-party insurance, such as automobile physical damage, are not new. As mentioned in Section 1, deductibles become increasingly inadequate with inflation. While index-linked deductibles are a logical solution, it appears that they are extremely difficult to adopt in practice. Competition in the past has forced the elimination of indexed deductibles. Furthermore, deductibles, particularly in automobile and

⁵One author has made a strong case that automobile insurance average claims are closely correlated with wage indices rather than a cost-of-living index. See Gunnar Benktander, "Inflation: Measuring the Problem," "Reinsurance" (Vol. 6, No. 12, April, 1975), pp. 597-603. Also see Munich Reinsurance Company, "The Influence of Inflation on Insurance" (Munich Reins. Co., May, 1971).

homeowners insurance, may be very unpopular with the public in some countries.⁶ A practical approach appears to be a periodic upward adjustment in the level of deductibles in those insurance lines where frequency of small losses is high. Education of policyholders on the function and advantages of deductibles may also be appropriate.

⁶For example, a recent survey in the United States revealed that the public perceives deductibles as benefiting only insurance companies. The study also found a strong dislike of compulsory deductibles. See J. Cummins, et. al., "Consumer Attitudes Towards Auto and Homeowners Insurance," (Dept. of Ins., Wharton School, U. of Pa., 1974).

Section IV

INVESTMENTS: CHALLENGES & OPPORTUNITIES

The impact of inflation on investments has probably been felt hardest by life insurers. The contractual guarantees are expressed in fixed currency amounts; and, in most countries, life insurance contracts are so drawn as to make the uncertainty of meeting these guarantees as low as possible. With regard to inflation, it has been implicitly assumed that investment performance, declining expenses, and declining mortality would exceed the contractual guarantees by a sufficient margin to offset price changes and preserve the real value of benefits and savings.

In the non-life area short-term policies and rate adjustment procedures have afforded a degree of flexibility in meeting guarantees not available to the life insurer. Non-life insurers have generally held shorter-term portfolios normally offering increased returns in periods of higher inflation rates, thus helping to offset increased losses.

Severe inflation, however, has brought challenges that have forced the insurance industry--life and non-life--to reconsider its traditional strategies of operation. In nearly every country inflation has raised costs beyond levels that can be countered by average productivity gains, raised non-life claims payments far above historic levels upon which premiums and reserves have been based, produced net losses in insurance operations that cannot be offset by investment income gains, and caused life policyholders to withdraw policy reserves.

Special measures to handle investment problems under inflation need be considered if inflation is to be a regular feature of market-based economies or is to recur in the form we have known it in 1974 and 1975 at some early time. Without going to extensive lengths to document the case, the prospect is that inflation will recur in the form we have known it these past two years. Age compositions of working populations, national and international liquid asset positions, armament expenditures, cartels among basic commodity procedures, market power of large unions and multi-national corporations, and growth-inducing government policies will probably combine to induce periodic hyper-inflation.

Some of the important questions involving investments are: (1) do sufficient opportunities exist for investments which offset inflation? (2) what are the extent and nature of investment regulations and restrictions, including restrictions involving life insurance policy loans? (3) are insurers taking advantage of all of the legally permitted types of investment which would tend to offset inflation? and (4) what are the possible options or remedies? With respect to the first question, investment opportunities to offset inflation are rare in most countries. In the long run, common stocks and real estate investments have developed sufficient yields to offset long-term inflation. But the requirements of yield, liquidity, and safety have proved incompatible in almost every country. High-grade common stocks have fulfilled the three criteria during most of the post-War period but have

failed miserably on the yield and safety side during the 1973-75 inflation.

INVESTMENT REGULATION

Investment Portfolio Restrictions

The composition of the investment portfolios is regulated in all countries, but not all countries face a maximum percentage for various investment types. In the United States, strict requirements apply to the proportion of equities in the insurer's portfolio. Prior to 1951, the important State of New York absolutely prohibited the holding of common stocks (valued at cost) by life insurers and, at the present time, the restriction is 5 percent of assets or one-half of policyholder surplus. These are far more stringent requirements than exist anywhere else in the world. In the United Kingdom, no restrictions exist except on investments in allied companies, and it is a requirement that the assets of other classes should be segregated from the long-term business assets. West German life insurers are restricted to 20 percent of the underwriting portfolio and 25 percent of other fixed assets in stock shares and investment funds and no more than 25 percent of their fixed assets in real estate and real property funds. In Belgium, Luxembourg, the Netherlands, and France, limits for equities are in the 30-65 percent range respectively for industrial stocks and real estate and mortgages.

In previous years, regulatory authorities, especially in Europe, encouraged investment restrictions more severe than those established by statute. This

practice has ceased with the greater development of capital markets. The Japanese regulatory restriction allows common stocks up to 30 percent of total assets and real estate up to 20 percent.

In many countries there has been a modification of restrictions that apply on the proportion of equity investments that may be in the insurance portfolio. However, insurers in most of these countries are not taking advantage of the legal permission they already have to hold equities. In Scandinavian countries insurers have taken advantage of the freedom to enlarge their portfolios to the limits provided for equities by law, and in the United Kingdom where no limit exists insurers have invested freely in equities and real estate.

Life Insurance Policy Loan Restrictions

Life insurers in the United States, Canada, Austria, and the Scandinavian countries are required by law to make policy loans. The degree of exposure of the life insurers to this drain of investment funds varies considerably, however, depending upon the policy loan rate. For example, within the United States, Canada, Japan, and Austria, there are requirements that policy loans be made at fixed rates. To be required to make policy loans at fixed rates is a form of jeopardy insurers must face in those countries with such restrictions. In other countries where the rate is variable, the problem is not so great as the loans can be made at the current short-term interest rates, and the interest can be altered from time to time as general interest rates change.

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Insurers required to make fixed-rate loans might compensate for the difference between the policy loan rate and current interest rates by adjusting the dividend payment formula where dividend distribution applies.⁷

This review indicates that opportunities are not readily available to allow insurers to offset the severe inflation experience by investment strategy. Moreover, insurers appear unwilling to take what opportunities exist and invest up to the legal maximums. Insurers are not, however, being negligent in their investment operations; they are instead in a dilemma in which criteria other than yield--safety, uninterrupted of income, and often liquidity, etc.--are dominant. Unless substantial changes can be introduced into the underwriting-investment process, there is little hope that the life or non-life insurers or insureds will be able to safeguard themselves against high-level inflation.

Possibilities for maintaining a "conventional" high yielding portfolio to meet inflation, e.g., real estate and equities, while at the same time assuring capital safety and liquidity include: (1) insurance stabilization funds; and (2) a "government lending facility of last resort," such as a central bank, or possibly a comparable private banking facility.

⁷A summary of policy loan restrictions and other investment factors for selected countries is contained in Appendix VII.

INSURANCE STABILIZATION FUNDS

The concept of a stabilization fund is that the relative bounty of the good years be in part reserved to cushion the bad years. In practice, stabilization has proved practical in government commodity reserve programs, the United States life companies' required Mandatory Security Valuation Reserve, deposit insurance schemes, and similar examples.

There is, of course, a great difference between pointing up the existence of a stabilization program and proving that a stabilization program would improve the ability of the insurance industry to bear the harsh economic weather expected over the decade ahead. It may well be the case that the concept of a stabilization reserve should be considered as a joint undertaking with the central government, the latter issuing special--possibly indexed--securities for the reserve fund. In any case, some approach independent of the operations of individual insurers should be considered in view of the risks confronting the industry and its public.

GOVERNMENT LENDING FACILITY OF LAST RESORT

Many of the traditional long-term investment operations of insurance companies have become less and less appropriate as policy loans, reduced prepayment of loans, and declining bond prices have created liquidity problems. A crisis in claim costs or unusual expenses, if continued over

a long period, forces investments into short-term, low-risk securities and prevents development of good anti-inflation strategy.

A principle has been applied to commercial banking with its heavy burden of short-term liabilities that may have application to insurance companies, principally life insurance. The central bank becomes a "lender of last resort" in order to permit commercial banks to meet current liabilities. This is accomplished through rediscounting commercial paper, buying bank-held government securities and similar liquidity-producing operations. A normal level of high-yielding investments can be maintained by the bank through occasional use of the rediscounting/lending facility. In the United States, provisional machinery for accommodating savings banks was arranged during a liquidity crisis in 1966. It would be a short step in principle for the central bank to extend accommodation to insurance companies as well. Investments could be maintained at high-yield levels during periods of adversity if high-grade securities could be "sold" to the central bank and repurchased without penalty or pledged for loans.

Finally, it may also be possible that private commercial banks--rather than the central bank--could provide lending facilities to individual insurers facing a liquidity problem.

INDEXED INVESTMENTS

Indexed securities are simply securities for which the principal and the earnings are explicitly compensated for changes in the general price level. Automatic protection against inflation is therefore provided by such securities, and they are an interesting possibility.

Private indexed securities are rare and little experimentation has occurred. The most notable adaptation of an index-linked security was that used in Finland. Finnish life insurers issued index-linked policies beginning in 1948 in which reserves were financed during inflation surges by partially indexed loans. But after 1968 indexed loans were frozen by law although life insurance policy indexing continued. Another example is that used by an insurer in the United Kingdom--the rents payable by the lessee of a hotel owned by the insurer are linked to the room rates.

In a severe inflation, the incentive to save tends to erode with harmful results for the economy. Some governments, therefore, have extended protection to various savings institutions by issuing indexed securities. Also, private institutions have issued indexed securities or financial instruments after the government introduced such securities.

Israel issued indexed securities beginning in 1958 for the benefit of life insurers. Interest-bearing securities of forty years maturity, both principal and interest linked automatically to the cost of living, were issued through the Israel Electric Company, a government-owned corporation.

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Life insurers were obliged to invest most of their reserves (except policy loans) in these securities. In turn, life insurers were able to issue index-linked policies in which premiums, cash values, and maturity values varied with a price index ratio. The Israeli system remains, from the policyholder's standpoint, the most equitable form of inflation-adjusted insurance product.

The government of Brazil issued indexed securities beginning in 1964. Readjustable National Treasury Obligations were bonds of one or two years' maturity in which the principal was adjusted monthly according to a three-month moving average of the wholesale price index. Other private institutions also issue indexed securities. Insurance policy indexing was accomplished in the mid-1960's. A notable increase took place in the amount and quality of Brazil's saving following the institution of indexing.

There is similar indexation of government and private financial instruments in Chile--a country with very high inflation rates. Banks and savings and loan associations readjust their savings accounts according to the cost-of-living index. Credit unions were recently legally permitted to index their loans and deposits; and life insurers began to sell fully indexed, individual permanent life insurance in 1970.

Section V

LOSS PREVENTION AND EXPENSE CONTROL

An important area in which insurers can act to mitigate the consequences of inflation is in the loss prevention and control of administrative expenses. In an inflationary period efforts to reduce losses and expenses are particularly relevant. Insurers can take direct, as well as indirect, actions to reduce the frequency and/or severity of losses under their insurance contracts. Reduction of losses and expenses can result in moderating insurance premium increases during inflation. Insurers around the world are involved in various loss prevention programs. Several are particularly promising.

PROBLEM OF AUTOMOBILE REPAIR COSTS

The inflation of automobile repair costs in many countries has been astounding--annual increases have been in the 15-40 percent range. Chart I indicates the increase of repair costs in the United States. Note that all of the changes in the indices for repairs exceeded the changes in the Consumer Price Index and also the automobile insurance premium index.

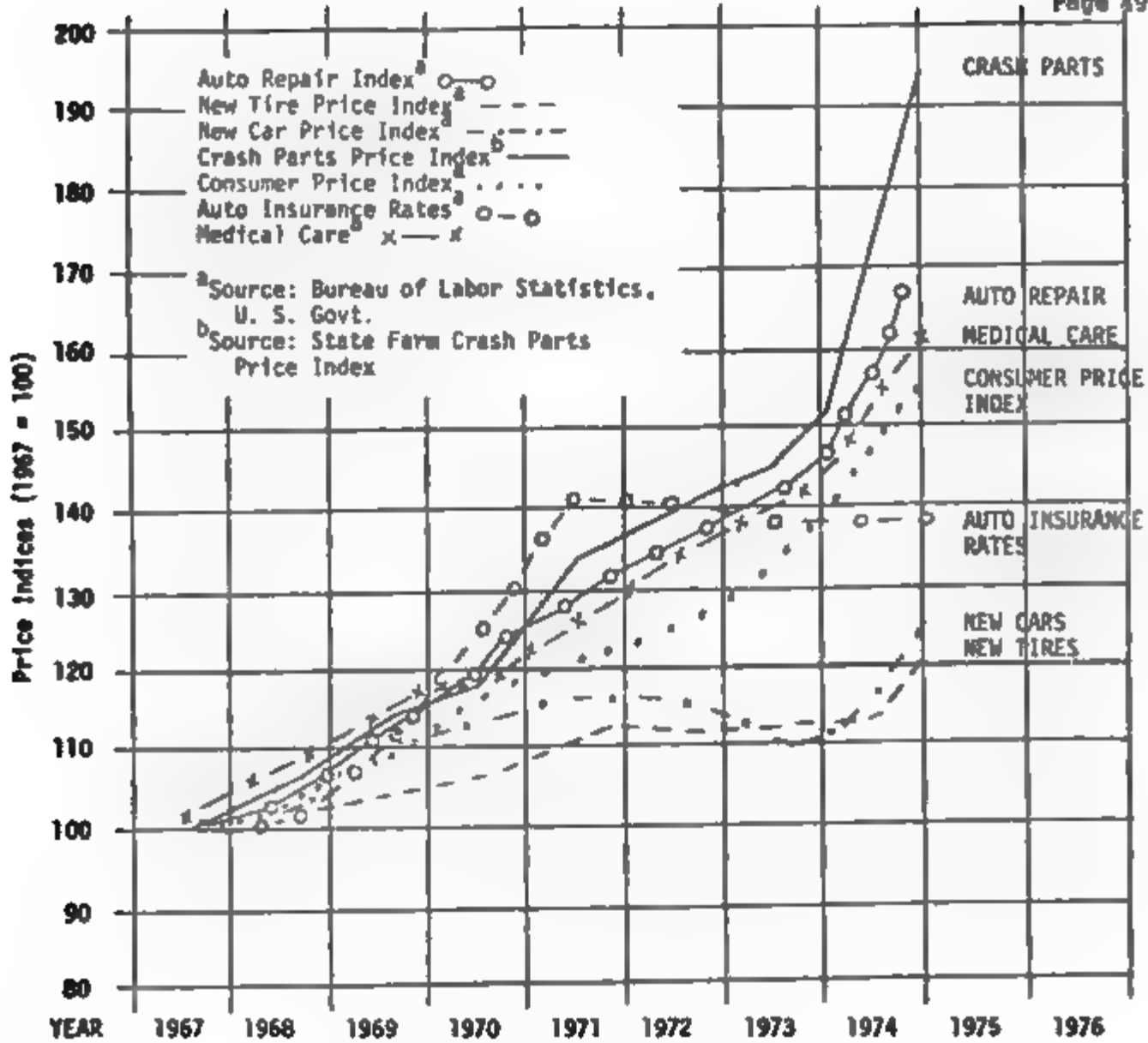
Appendix VIII also reveals the startling increase of the cost of repairs of front-end collisions of several model cars in the United States from 1970 to 1975. This table also reveals the relative increases in the costs of labor and parts. Similar increases have occurred in other countries. For example, auto repair costs in Canada rose 27 percent in eighteen months for the period ending July, 1975.

A survey of cooperative insurers, as well as other private insurers,

INDICES RELEVANT TO AUTOMOBILE REPAIR COSTS

Chart 1

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Year	Medical Care	Automobile Insurance Rates	Auto Repair Index	New Tire Price Index	New Car Price Index	Crash Parts Price Index	(CPI) Consumer Price Index
1963	85.6	78.8	91.6	91.5	109.4	85.9	91.7
1964	87.3	82.9	92.8	91.9	103.1	88.1	92.9
1965	89.5	90.8	94.4	94.2	100.8	93.0	94.5
1966	93.4	97.3	96.2	96.6	99.1	95.5	97.2
1967	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1968	106.1	102.3	102.9	105.6	102.7	107.1	104.0
1969	113.4	111.4	112.2	109.7	104.3	114.8	109.8
1970	120.6	126.7	120.6	113.1	107.4	117.0	116.3
1971	125.4	141.1	129.2	116.3	112.0	133.6	121.3
1972	132.5	140.5	135.1	115.9	111.0	140.9	125.3
1973	137.7	136.0	142.2	110.3	111.1	146.2	133.1
1974	150.5	136.1	156.8	110.4	117.5	175.9	147.7
1975	161.0	137.9	167.0	125.3	124.9	199.6	155.4

^aSource: Bureau of Labor Statistics, U. S. Government, BLS indices for 1963-1974 based on average prices over the entire year. The index for January, 1975 is based on average prices for the month of January, 1975.

^bSource: State Farm Crash Parts Price Index. The indices for years 1963-1974 are based on prices as of July 1 of each year. The index for January, 1975 is based on prices as of January 1, 1975.

revealed considerable activity in attacking this problem. Some countries of Europe are directly leading an effort to increase the productivity and/or introduce innovation in auto repairs and thus lowering cost. In Sweden, Folksam was the first to establish a crash-repair research facility in 1963. Such facility has developed technological repair innovations which have led to a reduction in labor and material costs. Cost of spare parts has also been reduced by establishing an organization for utilizing spare parts. Another innovation was the development of rating classifications for damageability and repairability of various models of automobiles. This new pricing system led to a reduction in the prices of spare parts from 10-26 percent by some automobile manufacturers. Similar research facilities have been established in the United Kingdom and have had considerable effect on the methods adopted by repair shops. Insurers in Norway have also founded an automobile damage institute and plans are being made to introduce a rating system based on repairability of various models of cars.

Insurers in France have jointly established a large, efficient auto repair facility; and Belgium has recently established a Center for Automobile Repairs which will repair automobiles directly, control prices and the duration of repairs, as well as conduct research on repair costs. The organization will also control prices and the duration of repairs at independent shops for repairs of insured vehicles. Some insurers in other countries are purchasing their own repair shops, entering into agreements with repair shops, or recommending to their insureds lower-cost repair

facilities in an attempt to moderate the inflation of automobile repair costs. Also, individual insurers in several countries, e.g., Austria, Germany, Japan, and the United States, have introduced sophisticated computerized systems of assessing automobile physical damage repair costs.

Insurers in the United States have been seriously negligent in not introducing and promoting innovations in auto repairs. The auto repair problem in the United States is massive, complex, and in need of major reform. Automobile manufacturers exercise a price monopoly on parts and the repair industry is powerful but inefficient.⁸ The only major effort has been the activity of the Insurance Institute for Highway Safety--an industry trade association. The Institute has conducted and publicized research on means of safeguarding passengers in motor vehicles and on damageability of various models of autos.

REHABILITATION

Insurers have become more sensitive to the need and usefulness of

⁸For a thorough analysis of the American scene see D. A. Randall and A. P. Glichman, The Great American Auto Repair Robbery, (N. Y.: Charterhouse, 1972). A recent survey has also indicated that the public in the United States is receptive to stronger action by insurers to control repair costs. See J. Cummins, "Consumer Attitudes Towards Auto and Homeowners Insurance," Op. Cit.

rehabilitation of accident victims. The health centers established by La Prevoyance Sociale and Zenkyoren which are open to the public are well-known to members of the I.C.I.P. Physical and vocational rehabilitation are socially beneficial. Where it applies to policyholders, it reduces the severity of losses and may produce substantial savings to the insurer. In some countries rehabilitation is a function of government. In some cases the financing of rehabilitation is by insurers. For example, in Belgium, a special government fund for rehabilitation is financed by special surcharge on auto liability and Workmen's Compensation premiums. There are other instances where insurers have directly established rehabilitation centers, e.g., Finland. In the United States, two states, Michigan and New Jersey, now require auto insurers to provide unlimited no-fault rehabilitation benefits to auto accident victims. Insurers in those states must therefore work closely with professional rehabilitation organizations, and some insurers have directly organized their own rehabilitation units.

OTHER LOSS PREVENTION EFFORTS

It is impossible to fully describe all of the indirect efforts of insurers to ultimately reduce losses. Individual insurers and their industry trade associations to which they contribute finance research and provide important information on loss prevention in areas such as fire, arson, fraud, theft, etc. Insurers have also promoted safety legislation. For example, insurers have supported and promoted mandatory auto seatbelt legislation.

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Zenkyoren of Japan has developed an interesting program of vehicle inspection--75,000 vehicles will be inspected in 1975. They have also conducted tests of drivers' competence using a computer for 120,000 drivers during 1975, as well as holding traffic safety classes.

EXPENSE CONTROL

Insurers have attempted to increase productivity and thus lower administration expenses. Electronic data processing has been employed by many insurers and is a continuing development. It is in the marketing area where potential large increases in productivity is possible. Group selling or "mass-marketing" of life and non-life insurance employing payroll deduction techniques is a growing trend in the United States. Selling costs have been reduced considerably. Samvirke of Norway has introduced several collective insurance solutions by marketing through large national organizations, including the development of homeowners insurance on personal contents for 290,000 trade union members. Folksam has also provided various coverages for trade union members required as a result of collective bargaining.

Another development in its infancy is group automobile insurance written as an employee benefit. The potential for reduction of marketing and underwriting costs and savings produced by integration of employee benefits is substantial. Although the technology for group plans exists, growth in the United States has been stifled mainly by the tax treatment

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of such plans .

The United States has been the leader in the development of no-fault automobile insurance legislation. Many cooperative insurers, such as League General Insurance Company and Nationwide, have been actively promoting such legislation. The elimination of the "fault" factor in auto insurance can produce important cost savings, as well as introduce more efficiency and equity in the compensation system. Also, important research is now being conducted on the feasibility of extending the no-fault system to other types of accidents now covered by third-party liability insurance. It should be noted that New Zealand has recently eliminated fault or tort liability for all accidents. The insurance is provided by a monopoly government fund.

Section VI

REINSURANCE

Reinsurance is an integral part of the insurance business; and a healthy reinsurance industry is indispensable to direct insurers and, of course, indirectly to their policyholders. It is not within the scope of this report to fully analyze the problems reinsurers face in an inflationary economy, but to explore those which are particularly relevant to direct insurers.

Many inflation problems of reinsurers are similar to those of direct insurers. Because reinsurers generally operate internationally, they also face the problem of fluctuating exchange rates. Differing inflation rates between countries contribute to this problem.

Special problems are caused by inflation for reinsurers writing non-proportional reinsurance contracts, especially excess-of-loss contracts. Inflation of claims paid by the direct insurer results in an increase in the number of claims exceeding the retention level and an overproportionate increase in the aggregate liability of the reinsurer to the ceding or direct insurers. In essence, the reinsurer bears a greater burden than the ceding companies when the rate of inflation is increasing.

Further, inflation and the delay problem in liability claims faced by direct insurers are magnified for reinsurers, particularly for large claim losses. For example, one authority has estimated that a 5 percent increase in inflation on all liability claims with an average settlement delay of four years on large claims will result in a 25 percent average increase in the

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claim cost for such large claims.⁹

In order to spread the increase in loss costs due to inflation more equitably between the reinsurer and primary insurer, "stability clauses" or index clauses have been included in excess-of-loss contracts in many countries. This clause links the retention limit in the contract to an index--generally a wage and salary index. Such clauses have not been universally applied. For example, in Canada and the United States the clauses have not had much of a history because until 1973 inflation rates have been relatively moderate and stable. But interest in the stability clause has increased in the United States as a result of the significant increase in the inflation rate. Two large reinsurers in the United States have recently introduced the clause in a substantial portion of their casualty portfolios.

The reinsurance market is very competitive. The issue is similar to that of applying index deductibles--competition has prevented universal application. However, due to heavy underwriting losses, it is expected that there will be increasing insistence by reinsurers to include stability clauses. The accelerating rates of inflation and any movement of direct insurers to index their policies sold to the public are factors which might encourage

⁹See Gunnar Benktander, "Inflation and Insurance: Measuring the Problem and Facing It," Op. Cit. For another excellent article on the impact of inflation on excess-of-loss contracts, see F. S. Guaschi, "Inflation Again: Its Effect on Accident Excess of Loss," "Reinsurance," (Vol. 6, No. 12, April, 1975), pp. 604-607.

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the adoption of such clauses. Presumably, there should be a close relationship between the index used to link direct premiums and the index in the stability clause. It might be added that the trend to government-mandated indexing of non-life insurance benefits may result in additional pressure by reinsurers to index excess-of-loss contracts.

Section VII

JAPAN: A CASE STUDY

It is useful to examine one country's experience with rising inflation rates and the actions of government and insurers to combat the problems inflation created. Japan perhaps provides an instructive model.

GOVERNMENT ACTION

Consumer prices in Japan began in 1960 a continuous increase of nearly 6 percent per annum. At the end of 1973 and the beginning of 1974, the period of the oil crisis, the price level dramatically rose--12.9 percent between November, 1973, and February, 1974. The price level in February, 1974, stood 26.3 percent above the level in February, 1973. As a result, the government of Japan began to take strong counter-measures. Both fiscal and monetary policies were employed to reduce aggregate demand. Furthermore, price controls were instituted, including a price freeze in many areas of the economy. The result has been that the inflation rate was reduced considerably. The rate of increase of consumer prices was only 14.2 percent in March and 10.3 percent in September, 1975, over the corresponding period of the previous year.¹⁰

¹⁰See Appendix IX for a more detailed discussion of government action in Japan.

ACTIONS BY INSURERS

The inflationary spiral produced predictable consequences for insurers in Japan: (1) demand for life insurance with savings features--which were the predominant form of life insurance--decreased dramatically; (2) under-insurance in property insurance increased; (3) claims and loss ratios in non-life insurance rapidly increased; and (4) insurer operation expenses rose significantly. The insurance industry in Japan acted swiftly in meeting the foregoing problem.

Life Insurance

An extraordinary shift in demand from life insurance with a savings element to term insurance occurred during 1973 and 1974. Life insurance companies responded by introducing individual term insurance contracts--group life insurance was previously the predominant form of term insurance. In addition, term insurance benefits, written as a multiple of the endowment maturity benefit, were added to endowment contracts. In 1975 index-linked term insurance contracts were added. The contracts are five-year term insurance under which the face amount and premiums are increased annually and are linked with the Consumer Price Index.

In order to preserve the goodwill of existing policyholders who held long-term, saving-linked life insurance, special extra dividends were paid. Companies declared extraordinary special dividends in 1974 which were

financed from capital gains.

To meet the problem of expenses exceeding the premium expense loading, various steps were taken. Older endowment policies with relatively small face amounts were liquidated by either: (1) paying the maturity value immediately; (2) deducting all future premiums from the face value; (3) converting into a paid-up policy; or (4) a special form of (3) to allow them to combine this paid-up policy from a number of existing policies for an increased face value.

Non-Life Insurance

Non-life insurers also took action to counteract problems created by the high rate of inflation in Japan. A system of indexed fire insurance and minimum co-insurance requirements is being introduced in 1975. In third-party automobile liability insurance companies adopted new systems of speeding up out-of-court settlements. Finally, franchised deductibles in automobile insurance were raised as a cost-savings device.

Although the inflation problems of Japan have not been completely eliminated, the foregoing illustrates what can be achieved by government and the private insurance industry when quick and remedial action is taken.

Section VIII

EXTERNAL RELATIONS

In many countries cooperative insurance represents a modest force when measured by relative premium volume or assets (there are, of course, some countries where cooperative insurers are a major market power). But the importance of cooperative insurance should not be judged solely on the basis of statistics.

Beyond the main mission of providing policyholders in its country the best service at the lowest possible price, the Commission believes that a cooperative insurer also has a special responsibility to be engaged in external action to: (1) avoid isolation; (2) promote solidarity with other cooperatives; and (3) assist in the solution of the problems facing the national and neighboring insurance markets. Cooperative insurers have close relationships with the cooperative movement and organizations of people. Thus, their actions can have a much greater influence than actions by commercial and capitalistic insurers.

In meeting problems caused by inflation, a cooperative insurer can act more efficiently when it is involved with: (1) the public in order to give objective information on all of the aspects of the inflation crisis and its consequences (not only will such activity be a public service, but it will also assist the insurer in safeguarding existing business and maintaining marketing strength); (2) various organizations where problems are discussed and resolved; and (3) the government authorities where important decisions are made.

A survey of the members of the ICIF revealed various relationships.

RELATIONSHIPS WITH THE PUBLIC

These relationships occur at various levels: public representation on the Board of Directors of cooperative insurers; public contacts through the sales organization, publications, conferences, panels, and, indirectly, through official and professional associations whose task is to inform and assist the public.

An interesting experiment to develop more effective communication between policyholders and the cooperative insurer is being undertaken by Samvirke in Norway. Forty insurance committees representing policyholders and headed by shop stewards in the largest plants all over the country have been established. Duties of the stewards include participation in developing products, responsibility for some education and sales activity in the plants, and, within certain limits, authority to settle losses.

RELATIONSHIPS WITH OTHER ORGANIZATIONS

Important contacts of cooperative insurers with other organizations include: (1) organizations of a cooperative nature (banking, housing, consumers, agriculture, tourism, etc.); (2) organizations of a socio-political nature (an example is Volkshilfe in Germany, which is directly represented in trade unions as well as in The Trade Union Council of the Social Democratic Party); (3) organizations of a professional nature--most insurance

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cooperatives are members of their national insurance associations and committees. De Centrale (Holland), for instance, and La Prévoyance Sociale (Belgium) have key positions in their respective national Insurance Committees. Cooperative insurers are also represented in official organizations such as the Advisory Committees of Insurance Supervisory (for example, Kanssa in Finland).

RELATIONSHIPS WITH GOVERNMENTAL AUTHORITIES

Acting within the political process, cooperative insurers maintain direct contact with government and exert a positive and constructive influence on legislation.

These governmental authorities should be encouraged to take positive actions to promote legislation and programs which assist policyholders and insurers in meeting inflation problems and which attack the basic causes of inflation.

GLOSSARY

Some important terms and some important differences between British and American terminology are listed below.

Deductibles

A deductible is an amount deducted from the total loss before the claim is paid. In British terminology, this type of arrangement is known as an excess. A deductible is also referred to as a retention in some countries.

A franchised deductible is one in which the insurer pays nothing on a claim that is less than the amount of the deductible, but pays the full amount of the claim if it exceeds the deductible.

Face amount or Face value

The face amount or face value of a policy is the sum assured in British terminology.

Insurance

American usage of the term "insurance" covers both insurance and assurance in British usage.

Permanent insurance

Permanent insurance is life insurance with a savings element, such as whole life or endowment insurance.

Present value

The present value of a benefit or a premium is the amount discounted by a given interest rate after allowing for the risk element in payment.

Policy reserve

The policy reserve, or technical reserve, is the present value of the benefit less the present value of outstanding (future) premiums. Allowance is generally made for future expenses also.

Term insurance

Term insurance is life insurance without a savings element. It is also referred to as temporary insurance.

Appendix I

Table I

Percentage Increases in
Consumer Price Index

	<u>1961-70</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975*</u>
Canada	2.7	2.9	4.8	7.5	11.0	10.8
United States	2.8	4.3	3.3	6.2	11.0	9.1
Japan	5.7	6.3	4.9	11.7	23.2	11.2
Australia	/ 4.0	6.1	5.8	9.4	15.1	14.5
Belgium	3.0	4.3	5.5	7.0	12.7	12.8
Denmark	5.9	5.5	6.9	9.3	15.0	10.8
Finland	5.1	6.0	7.5	10.5	17.5	17.6
France	4.0	5.5	5.9	7.3	13.7	11.7
West Germany	2.7	5.3	5.5	6.9	7.0	5.8
Iceland	12.1	7.0	9.3	20.5	43.3	51.5
Italy	3.9	5.0	5.6	10.4	19.4	17.0
Netherlands	4.3	7.5	7.8	8.0	9.6	10.6
Norway	4.6	6.0	7.5	7.0	9.8	11.9
Sweden	4.1	2.8	6.5	6.1	13.8	9.0
Switzerland	3.3	6.6	6.7	8.7	9.8	6.6
U. K.	4.1	9.5	6.8	8.3	16.0	23.0

* Estimated.

/ Percentage increase 1970 over 1969; no earlier figures available.

The increases are the percentage by which the average index figure for each calendar year exceeds that for the previous year.

Source: OECD, "Main Economic Indicators," 1970 and December, 1975.

Appendix I

Table V

Average annual inflation rates 1966/70 and 1970/74 in %

EUROPE					
	1966/70	1970/74		1966/70	1970/74
E. Germany **	0.0	- 0.3 ⁴⁾	Switzerland	3.2	7.9
USSR **	0.1	- 0.1 ⁴⁾	France	4.7	8.1
Bulgaria **	0.9	0.0 ⁴⁾	Netherlands	4.6	8.3
Czechoslovakia *	2.3	0.1 ⁴⁾	Denmark	6.5	9.2
Romania **	0.5	0.5 ⁴⁾	Italy	3.2	10.0
Poland *	1.4 ¹⁾	1.6	Finland	4.9	10.1
Hungary *	0.8	3.1	United Kingdom	4.7	10.4
Malta	2.2	5.2	Spain	4.8	10.9
W. Germany	2.3	6.2	Ireland	5.8	11.4
Luxembourg	2.9	6.4	Greece	1.9	12.1
Austria	3.5	7.0	Turkey	7.9	14.6
Belgium	3.3	7.3	Portugal	6.7	15.0
Sweden	3.9	7.4	Yugoslavia	8.2	18.5
Norway	5.3	7.6	Iceland	11.8	19.1

ASIA					
	1966/70	1970/74		1966/70	1970/74
Afghanistan	7.4 ²⁾	2.0 ⁷⁾	Japan	5.6	11.2
Iraq	4.2	5.5	South Korea	11.2	12.6
Lebanon	1.9	5.9	Singapore	1.0	12.6
Sri Lanka	5.3	7.7	India	5.2	13.0
Malaysia	1.1	8.0 ⁷⁾	Pakistan	4.2	13.2
Cyprus	2.3	8.1	Taiwan	4.6	13.7
Iran	1.9	8.6	Philippines	6.0	17.2
Nepal	6.6	9.1	Indonesia	68.5	19.7
Thailand	2.3	9.9	Israel	3.1	20.7
Syria	2.9	10.0	Laos *	4.1	25.5
Hong Kong * (GB)	4.9	10.3	Bangladesh *	4.0	29.0 ⁷⁾
Jordan	3.5	10.6	South Vietnam	32.1	35.0
Kuwait		10.8 ⁶⁾	Cambodia *	5.9	106.5 ⁷⁾

Source: "Sigma," Swiss Re, No. 7, July, 1975.

Appendix 1

Table 2 (cont'd)

Average annual inflation rates 1966/70 and 1970/74 in %

AFRICA

	1966/70	1970/74		1966/70	1970/74
Ethiopia	3.1	2.8	Senegal	1.6	7.0
Zambia	5.2	3.6	Malawi	5.1	8.0
Somalia	2.5	3.0	Cameroon	2.4	8.2
Upper Volta	1.6	3.8	South Africa	3.2	8.3
Rhodesia *	1.6	3.9	Liberia *	4.7	8.7
Tunisia	2.6	4.2	Mauritania	5.4	8.9
Egypt	2.9	4.7	Kenya	1.0	9.0
Libya	5.0	4.9	Nigeria	4.7	9.0
Congo	2.0	5.7	Madagascar	2.1	9.6
Sierra Leone	4.3	5.7	Tanzania	2.6	9.9
Gabon	2.7	6.3	Réunion * (Fr)	2.4	10.0
Chad	4.1	6.4	Mauritius	3.2	11.5
Ivory Coast	5.3	6.5	Mozambique *	3.7	11.8
Morocco	1.0	6.5	Rwanda	1.5	12.0
Gambia	2.1	6.9	Ghana	3.0	13.2
Niger	2.2	7.2	Sudan	4.0	13.3
Burundi	2.1	7.3	Zaire	25.3	16.5
Togo	2.0	7.6	Uganda	5.3	23.5
Central African Republic	2.7	7.8			

NORTH AND CENTRAL AMERICA

	1966/70	1970/74		1966/70	1970/74
Bahamas *	6.2	3.1	Panama	1.9	7.6
El Salvador	1.7	6.1	Puerto Rico (US)	3.4	8.5
United States	4.6	6.2	Dominican Republic	1.5	10.0
Honduras	2.1	6.3	Bermuda ** (GB)	6.2	10.7
Canada	3.9	6.5	Mexico	3.3	11.0
Guatemala	1.7	7.0	Haiti	0.3	12.6
Costa Rica	3.2	7.5	Jamaica	6.2	14.4

Appendix I

Table 2 (cont'd)

Average annual inflation rates 1966/70 and 1970/74 in %

<u>SOUTH AMERICA</u>					
	1966/70	1970/74		1966/70	1970/74
Venezuela	1.5	4.7	Paraguay	0.9	12.8
Netherlands Antilles (NL)	1.3	7.3 ⁵⁾⁷⁾	Ecuador	4.9	13.0
Guyana	2.7	7.6	Colombia	7.7	17.5
Surinam (NL) *	6.6	7.9 ⁷⁾	Barbados *	6.1	18.2
French Guiana (Fr) *	4.0 ³⁾	9.0	Brazil	23.9	19.1
Guadeloupe (Fr) *	5.4	9.2	Bolivia	5.7	24.0
Martinique (Fr) *	4.8	9.6	Argentina	16.4	43.6
Peru	9.9	10.0	Uruguay	56.6	67.9 ⁷⁾
Trinidad & Tobago	3.8	12.2	Chile	26.8	287.3 ⁷⁾

<u>OCEANIA</u>					
	1966/70	1970/74		1966/70	1970/74
French Polynesia (Fr) *	5.6	8.6 ⁷⁾	New Zealand	5.5	9.1
New Caledonia (Fr) *	4.7	8.7	Fiji *	2.6	10.3
Australia	3.2	9.1			

N.B.:

- | | |
|------------|---|
| 1) 1967/70 | 5) 1971/74 |
| 2) 1968/70 | 6) 1972/74 |
| 3) 1969/70 | 7) Not all monthly figures available for 1974;. |
| 4) 1970/73 | (average of less than 12 months) |

Sources

Where not specified otherwise:	IMF International Financial Statistics
*	UN Monthly Bulletin of Statistics
**	ILO Yearbook of Labour Statistics

APPENDIX II

CASE STUDY: GERMANY IN THE TWENTIES

This paper deals briefly with how the German insurance industry faced up to the challenges and problems which arose as a result of the rapid inflation after World War I.

The policy of "easy money" started in Germany during the early days of the 1914/18 War but it was not until after the war that the full force of inflation was felt.

The conversion rate of paper marks to gold marks gives a pretty clear idea of the accelerating rate of the domestic inflation.

Gold Mark Value of 10,000 Paper Marks

	1918	1919	1920	1921	1922	1923
April 1st	8,000	3,410	700	724	143	2.02

By November 20, 1923, 1 gold mark was equal to 10^{12} paper marks.

The German insurance industry suffered the full force of these changes, and insurers who were unable to renew foreign business and to earn foreign exchange were exposed to the danger of insolvency. At the height of inflation insurance based on the mark became worthless.

Throughout the property insurance field continuous monetary depreciation resulted in neither the amounts insured nor the premiums keeping pace with the inflated price situations. Over-insurance was permitted in the hope that the insured amount would be adequate if a claim arose, but because the insured amount was higher than the value of the property, policyholders were tempted to commit arson in order to claim the high indemnity benefit. People were anxious to obtain any article with real value which could be bartered for food stuffs and other necessities. There was, therefore, a ready market for stolen goods, and burglary and glass insurance companies had catastrophic losses.

Due to continuous increase in prices, claims were seldom settled for less than the maximum insured amount even when the loss was only partial, and because of the constant increase in prices for materials and labor, it was no longer possible to repair or reinstate the property. "Providence insurance" introduced in 1916 contained a clause permitting both the insured amount and premium to change, if the price of glass changed.

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This was the first indexed property insurance. It failed because the prices increased too rapidly for the adjustments to be handled administratively.

There was no automatic relationship between the insured amount and values of buildings insured. Reassessment of the risk was only permitted after five or more years had elapsed since the previous assessment or if structural alterations had been made. This resulted in a permanent under-insurance. Supplementary insurance became necessary and was in most cases taken out with the competitors of the institution holding the compulsory insurance. Calculation of the premiums on traditional lines became too expensive and so they were calculated by rule of thumb. To further reduce expenses coupon policies for supplementary insurance were issued for standard amounts of 5, 10 or 20 million of marks, on which the premium was already printed. These could be purchased freely by postal money order. The receipt of the post office was regarded as receipt by the company and the date stamp as the date on which the cover took effect.

Foreign currency insurance was a special problem. Industries importing raw materials were anxious to effect fire insurance in foreign currency. Such insurance required authorization by the Supervisory Authority who wished to avoid authorizing it in order to support the German currency as far as possible. This led to the withdrawal of a large part of the export industry from Germany to foreign countries.

Early in 1923 the foreign currency insurance was easier because a notional currency was introduced. The "fixed mark insurance" was based on the "duty surcharge on gold," and "Gomadoba" (gold mark dollar basis) insurance based on the peace time parity of 1 US \$ = 4.20 marks was introduced but it suffered because dealings in foreign exchange were very restricted. However, the introduction of the "Rentenmark" in November, 1923, made this insurance completely stable.

Due to the monetary decline insurers did not want to underwrite liability insurance at all.

With the substantial increase in prices the average costs of claims rose dramatically. The free reserves and the reserves for future bonuses for the policyholders melted away. Insurers worked at a loss. On January 1, 1921, the Supervisory Authority authorized a price increase on existing contracts, and the contracts could be cancelled if the policyholder refused to pay the increase. In July, 1921, the Supervisory Authority recognizing that a once for all increase was ineffective allowed insurers to use a "compensation index" which permitted insurers to adjust premiums in accordance with the changes in the cost of living index. But again the adjustment when provided was too little and too late and by 1923 the adjustment no longer had any value to the insurers.

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Ordinary life insurance in force was approximately 14 billion marks in 1913 and had increased to 23.5 billion marks in 1920, but in terms of purchasing power in 1913, decreased to 2.5 billion marks. Increasing amounts of insurance were required to compensate for the diminishing purchasing power, but to achieve this, it would have been necessary to create reserves which kept pace with inflation. In times of inflationary circulation of notes, this was not possible, and attempts were made to try to compensate for the falling currency by mixed investments.

Mixed investments became possible in 1923 when a modification of the Imperial Supervisory Law permitted up to one-half of the legally required reserve to be invested in domestic real estate, in secure short-dated bonds issued by any kind of solvent commercial, industrial, trade or agricultural enterprise, and in shares of domestic joint stock or limited partnership stock companies. This concession to the German life insurers was of little help for the holders of mark policies, who before 1914 had paid in gold, and after 1922 found there were no bank notes in existence small enough to pay the premiums.

An insured amount of 25,000 marks with which the policyholder in 1918 would have been able to buy a house was insufficient to pay the postal charges which would have been required to send the sum due on a claim to the beneficiary. The inflation of costs had literally eaten up the mark life insurance.

The inventiveness of the insurers in their attempts to continue to operate with fixed values deserves high praise, but the means available were too crude to be successful when the national currency had been abandoned.

Appendix III

Table 1

STOCK MARKET INDICES

	<u>Index Movement</u>			
	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975 Year to Date</u>
Australia	+20%	-27%	-33%	+32%
Belgium	+25	+ 3	-29	+12
Canada	+22	- 4	-27	+13
France	+16	--	-32	+25
Germany	+12	-21	+ 1	+19
Britain	+ 6	-32	-53	+105
Holland	+47	-18	-17	- 2
Hong Kong	+147	-49	-61	+79
Japan	+92	-17	-11	+ 1
Sweden	+16	- 6	- 8	+29
Switzerland	+16	-27	-37	+13
United States	+15	-17	-28	+29

Source: "The Business Week Letter," (Vol. VIII, No. 10, Oct. 20, 1975, adopted from chart provided by Fiduciary Trust Co. of New York).

Appendix IV

**Indexed Family Income Plan
Of Legal and General Insurance Company (United Kingdom)**

Looking after your family's future

If anything happened to you, your family would desperately need a guaranteed regular income – to pay for all the things you pay for now.

But what kind of an income? In today's conditions it's vital that it should be protected against the effects of inflation.

For that reason we have revised our Family Income Plan.

Under the old Plan, you could provide for your family with an income that stayed the same throughout the policy. We now call this Option One.

The new Plan offers you a new option, Option Two, which is specially designed to take realistic account of inflation. It includes these two special features:

- A.** The income guaranteed to your family will be adjusted every year in line with the rise (or fall) in the cost-of-living, as measured by the official Retail Price Index, for as long as you're alive and paying the necessary premiums.
- B.** Should you die, the income paid to your family will automatically be raised every year by 10% compound.

We believe that it's only with an option like this that you can provide the realistic cover your wife and children need in an age of inflation.

Let's look at the Plan in more detail.

How much income?

That depends on you. You should work out roughly how much your wife and children would need to spend each month on essentials, like food, heating, rates or rent, new clothes and so on. Do it thoroughly and you'll almost certainly find it's more than you think – it could easily be £150 or more a month.

Option One (without index-linking)

Say you decide to guarantee your family an income of £150 a month. This income will remain fixed throughout the whole period of the policy.

Paying for this

The premiums you pay vary according to age. Starting at 25, with a 15 year policy, you'd pay £1.55 a month; at 35, £2.75 a month for the same period.

The premiums remain the same throughout the whole period of the policy.

If you die

Your family will receive the income you guaranteed them (£150 a month in our example) till the end of the policy. They do not have to pay any more premiums.

Option Two (with index-linking)

Say you decide to guarantee your family an initial income of £180 a month. With your continuing agreement this amount will be increased (or decreased) every year by the same percentage as the change in the official Retail Price Index. * For example, if the index goes up 12% in the first year, so does the income guaranteed, to £186 a month. If the index goes up 8% in the second, so does the income, to £181 a month. And so on year by year.

This gives you the peace of mind of knowing that the guaranteed income will keep its purchasing power over the years – and you won't need to keep arranging extra insurance to bring your cover up to date.

*For the sake of simplicity the increase (or decrease) in the index is measured as yearly intervals starting from the month six months prior to the date of taking out the policy. The amount of income will only be adjusted if the change in the index exceeds 1%.

Paying for this

The premiums you pay also vary each year – again, by the same percentage as the rise (or fall) in the official Retail Price Index. If the index goes up 12% in a year, then the income goes up 12% – and the premium goes up 12% too. And so on every year. It couldn't be simpler.

To give you an idea of the initial cost of premiums: a man aged 25, with a 15 year policy, would pay only £2.45 a month. A man aged 35 would pay only £3.35 a month for the same period.

If you're worried at the idea of the premiums increasing at a rate you can't predict remember these things: Firstly, the initial cost is low. Secondly, you can discontinue index-linking if you wish so that the premiums (and the guaranteed income) would cease to vary. (See method of payment). Thirdly, your salary or wages are likely to be increasing all the time to keep up with inflation so that the actual proportion of it you pay in premiums should remain pretty well constant.

What if you die?

The income still goes on being raised – by 10% every year – although no further premiums have to be paid. Of course, no-one knows what the future rate of inflation will be. We believe 10% is a reasonable estimate – indeed it may well exceed the actual rate of inflation in the long-term.

Even if the actual rate turns out to be more than 10%, the rise in your family's income will certainly cushion the impact of inflation.

Method of payment

We'll tell you well in advance of any change that's needed in your premium. If you have decided to pay through your bank by Direct Debit, then each year, once we've received your consent, the change will be handled automatically. This will save you the trouble of filling in new bank forms.

The only alternative method of payment besides Direct Debit is by remittance to the Society on a quarterly, half-yearly or yearly basis.

If for any reason you do not wish to pay the changed premium, then you can continue to pay at the same level – and the income guaranteed will stay the same. (If you die, the income paid to your family will still increase by 10% every year).

However, once you have discontinued index-linking you cannot return to it.

Your next step

Our new Family Income Plan offers you the best way of giving your wife and children the kind of protection – including realistic protection against inflation – which every family needs in today's conditions.

To find out more about how the Plan could be suited to your particular circumstances, just send off the reply-paid card. One of our experts will be glad to meet you and answer all your questions.

Appendix V



LEAGUE LIFE INSURANCE COMPANY

P.O. BOX 35-150 • DETROIT, MICHIGAN 48235 PHONE (313) 567-3240

INSURANCE FOR



MEMBERS

Here is good news

Soon your Family Group Life insurance will be worth more than ever before.

On September 1, 1975, the insurance benefits under the Family Group Life II plan will be automatically increased by 20 per cent. Here is the new insurance schedule for you and the members of your family covered under this plan:

Your Insurance	Age at Death	Husband or Wife's Insurance
\$ 24,000	16 through 29	\$ 12,000
18,000	30 through 34	9,000
12,000	35 through 39	6,000
9,000	40 through 44	4,500
6,000	45 through 54	3,000
3,000	55 through 64	1,500
1,200	65 through 74	600
600	75 and over	300
Unmarried children:	birth through 5 months	\$ 600
	6 months through 22 years	2,400

Your policy provides these increases in your insurance to help your family's protection keep pace with the cost of living. The original benefit levels grow 10 per cent for each 10 per cent increase in the Consumer Price Index from the May 1973 level. (Since May 1973 the Index has gone up by just over 20 per cent.) Premiums for your insurance will be increased by the same percentage from \$1.00 a week to \$1.20 weekly starting with the one due September 1, 1975. The earliest date for the next cost of living adjustment will be in two years--September 1, 1977.

We have also enclosed an endorsement which expands your rights to convert your Family Group Life II insurance to another type of life insurance.

If you do not want the higher amounts of insurance and the new conversion rights, you may complete the enclosed card and return it to receive information on insurance with the same benefits and cost as you now have.

If you want the increased insurance...you don't have to do anything except have enough money in your credit union share account to cover your premiums. The increase is automatic, regardless of any change in health since the day you became insured under Family Group Life II.

Sincerely,

Robert E. Vandenberg
President

Appendix VI

Minnesota Mutual Life

PLAN DESCRIPTION--
ADJUSTABLE LIFE POLICY

I. A New Concept

Adjustable Life is a new concept in life insurance -- not just another life insurance policy.

It allows the policyowner to adjust both the death benefit and the premium of the policy from time to time as circumstances change . . . all through a single policy! Thus Adjustable Life offers the ultimate in flexibility among today's guaranteed dollar life insurance products.

The insured, guided by the recommendations of the agent, can create and maintain a complete life insurance program using Adjustable life. Periodic adjustments in a single Adjustable Life policy will provide the same benefits as any combination of traditional policies. Therefore, this one policy could meet most of an individual's needs for life insurance as those needs varied throughout life -- literally a life cycle policy.

Adjustable Life is an amazingly versatile and flexible instrument. A person's family and business needs may change drastically during the course of a lifetime, but unlike a house or a car Adjustable Life will not become outmoded. It offers, in essence, a simple and economical method of fitting life insurance to family and business requirements.

II. A Computer-linked Innovation

The Adjustable life policy is a computer-linked innovation. In fact, its great flexibility would not be feasible without the capabilities of a computer.

The policy is actually custom-built by the computer. It is constructed from two basic specifications provided by the applicant: (1) the face amount of insurance and (2) the annual premium. The computer then determines the plan of insurance.

Plans of insurance must lie in a range from coverage for 5 years (similar to 5 Year Term) to coverage for life with premiums payable for at least 5 years (similar to 5 Pay Whole Life). Thus, in a single policy, Adjustable Life offers a tremendously wide variety of durations of coverage and periods of premium payment. It can reproduce any policy regularly issued by the Company (premiums will be similar but not identical) except endowment, retirement income, and annual renewable term policies.

The face amount, premium, values and benefits for an Adjustable Life policy are itemized by the computer on a special page (Policy Schedule and Table of Non-forfeiture Values), which becomes Page 2 of the policy.

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The policy may be issued at ages from 0 through 60 (male and female), subject to a minimum face amount of \$2,000.

III. The Adjustment Provisions

The tremendous flexibility of Adjustable Life is made possible by the unique adjustment provisions of the policy. These provisions provide the means whereby the policyowner may periodically update the policy as dictated by changing circumstances.

Two types of adjustments are permitted. First, the face amount of insurance may be increased or decreased. Increases, of course, would be subject to evidence of insurability. Evidence would not be required for decreases. (Note: Refer to the sections of this bulletin entitled The Cost of Living Benefit and The Optional Benefits for information about increases in face amount without evidence of insurability.)

Second, the premium may be increased or decreased on any premium due date. Evidence of insurability would not be required for either an increase or decrease. In addition, a nonrepeating premium (\$500 minimum currently) may be paid at any time. This single premium type arrangement allows the policyowner to transfer larger sums (inheritances, windfalls, side fund accumulations, etc.) to the policy for retirement or estate planning purposes.

When updating an Adjustable Life policy, the policyowner may utilize either of the adjustment provisions, or both of them, on a given premium due date to produce the desired policy change.

Whenever adjustments are made, a new plan of insurance will be determined by the computer, taking into account the cash value of the policy in effect prior to the adjustment. A revised Page 2 will be prepared, itemizing the new premium, face amount, nonforfeiture values, etc.

IV. The Policy Values

The nonforfeiture values of the Adjustable Life policy are (1) cash values and (2) reduced paid-up insurance (paid-up whole life insurance regardless of the plan of insurance). The automatic option is reduced paid-up insurance. Extended term insurance is not available; however, the automatic premium loan provision (A.P.L.) is available.

All Adjustable Life policies, including those on a term type plan of insurance, have nonforfeiture values. This differs from the usual practice of allowing cash values on term policies only if the duration is at least 15 years.

It is important to keep in mind that the actual cash value of an Adjustable Life policy after, say, 10 or 20 years will depend not only on the premium per thousand paid at time of issue but also on the number and extent of changes made in premium and face amount over the years.

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For example, a policy may be issued on a term type plan of insurance which provides coverage for, say, 11 years. If no changes are made during the 11 years, the cash value would gradually increase until about the 9th year and then decrease to approximately 0 at the end of the 11th policy year. However, if the premium increased periodically (without any changes in face amount), the cash value would continue to increase in proportion to the premium paid; and, assuming that the plan of insurance eventually changes to a life type, the cash value would be similar to that of a regular Whole Life or Limited Pay Life policy.

Finally, all Adjustable Life policies are participating, with the first dividend payable at the end of the second policy year. Dividend options currently available are (1) cash, (2) reduce premium, (3) paid-up additions, and (4) accumulations. Again, the paid-up additions are paid-up whole life insurance regardless of the plan of insurance of the policy.

V. The Cost of Living Benefit

A cost of living benefit is automatically included in each Adjustable Life policy issued at ages 0 through 32 (without specific premium charge) unless the insured does not qualify for the benefit or elects not to have it included.

This benefit provides that, if there is an increase in the Consumer Price Index (C.P.I.) the face amount of the policy will automatically be increased without evidence of insurability. Such increases will occur every third year from the original date of issue or every third year following the most recent increase or decrease in face amount, and will continue to occur on that basis through age 35. The amount of each increase will be the percentage increase in the C.P.I. for the most recent 3 year period (but not more than 20%), subject to a maximum increase of \$20,000 at any one time. A decrease in face amount may not occur under this benefit.

As each increase in face amount is made the annual premium will also be increased by an amount sufficient to maintain the existing plan of insurance.

The policyowner may decline an increase in face amount under this benefit; however, the benefit would then cease to be operative. If this should occur, the benefit could subsequently be reinstated; however, evidence of insurability would be required.

VI. The Waiver of Premium Disability Benefit

Each policy automatically includes a disability waiver benefit (without specific premium charge) unless the insured does not qualify for the benefit. Premiums are waived if disability occurs after age 10 and before age 60.

The operation of this benefit depends on the plan of insurance in effect at the time of disability. If the plan of insurance provides coverage to a stated age (term type plan), premiums will be waived during disability to the end of the period of coverage; then, the plan of insurance will automatically be changed to

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a life type plan with premiums payable to age 100, and the resulting larger premium will be waived. On the other hand, if the policy is on a life type plan of insurance with premiums payable to a stated age (limited pay life) when the insured becomes disabled, the plan of insurance will automatically be changed to a life type plan with premiums payable to age 100, and the resulting smaller premium will be waived.

Adjustments in face amount or premium (other than those just described) are not permitted while premiums are being waived unless the policy includes the Face Amount Increase Agreement. (Note: Refer to the section of the bulletin entitled The Optional Benefits for information about automatic increases in face amount on regular option dates in the event of disability.)

VII. The Optional Benefits

Three optional benefits may be added to the Adjustable Life policy, with payment of an additional premium (1) Face Amount Increase Agreement (similar to A.I.O.W.), (2) Family Term Agreement - Children, and (3) Accidental Death Benefit Agreement.

The Face Amount Increase Agreement permits the policyowner to increase the face amount of the policy without evidence of insurability on each of 6 regular option dates (ages 23, 28, 31, 34, 37, and 40), as well as a special option date for graduation from college a total of 7 option dates. Alternate option dates are available in place of the regular option dates in the event of marriage or the birth or adoption of children.

The amount of each increase is limited to the face amount of the original policy, subject to a maximum of \$25,000; however, special limits are available at younger issue ages (5 times the policy face amount at ages 0 through 14, and 2½ times the policy face amount at ages 15 through 23, subject to the maximum of \$25,000).

As each increase in face amount is made on an option date, the policy premium will be increased by an amount sufficient to maintain the existing plan of insurance unless the policyowner also requests an adjustment in premium at the same time.

If the insured is disabled on a regular option date, the face amount will automatically be increased and the additional premium required to maintain the plan of insurance will be waived. The Face Amount Increase Agreement cannot be issued without this disability feature.

Each unit of the Family Term Agreement provides \$1,000 of level term insurance from age 14 days to age 25 on each insured child. (No coverage is provided on the wife.) This insurance may be converted at any time without evidence of insurability. If the conversion occurs when the insured child reaches age 25, the amount of the converted policy may be up to 5 times the amount of insurance under this Agreement.

The Accidental Death Benefit Agreement provides accidental death coverage during the premium paying period of the policy up to age 70. The benefit is doubled if death occurs as a result of a common carrier accident. And, exclusions include the following: suicide; commission of, or attempt to commit, a felony; bodily or mental infirmity, illness or disease, drugs, poisons, or gases; bacterial infection; aircraft travel other than as a passenger; war.

Appendix VII

CURRENT INVESTMENT PRACTICES
Selected Countries
1976

Areas of Information		U.S.A. Canada	United Kingdom	Japan	N. Germany Austria Switzerland	France Belgium	Scandinavia	Italy
1.	Sufficient investment opportunities to offset inflation?	No	No	No	No	No	No, generally	No
2.	What forms of investment?	--	--	--	--	--	Norway-Bank Estate Sweden-Bank Finland-Bank Estate	No
3.	Legal requirement for policy loans?	Yes	No	Yes	Germany-No (but generally granted) Austria-Yes	No	Yes	No
4.	Policy loans at fixed rate?	Yes	No	Yes	Germany-No Austria-Yes	No	No	No
5.	Are maximum percentages of various investment types regulated?	Yes	No, except in allied companies	Yes	Yes	Yes	Yes, except in Finland	No
6.	Do regulators encourage deviations from maximum requirements?	No	No	Yes (less than max. in real estate)	No, but occasionally permit	No	No	--
7.	Are insurers taking advantage of all the investment types permitted?	No	Yes	No	Germany-various company to company Austria-Yes Switz.-No	No	Yes	No
8.	Any special regulation of indexed policies?	Yes	No	No	No	No	Yes	No
9.	Are regulatory criteria an impediment to development of inflation-correcting products?	Yes	No	No	No	No	No	No

Appendix VIII

1970 and 1975 CHEVROLET IMPALA 2-DOOR

*Cost of fixing front-end collision of 1970 Chevrolet 2-door Impala in 1970, and cost of fixing 1975 Chevrolet 2-door Impala in 1975. Damage is to fender, bumper, grille, hood, headlamp, radiator, windshield, fan and waterpump.

	1970 CHEVROLET IMPALA	1975 CHEVROLET IMPALA	PERCENT INCREASE 1970-75
Parts	\$ 858.95	\$1,030.20	+56 percent
Labor	143.20 (17.9 hours @ \$8 per hour)	215.00 (21.5 hours @ \$10 per hour)	+50 percent
Total	882.85	1,245.20	
Tax (4 percent)	23.88	36.90	
* Total cost of repairs	\$ 906.73	\$1,282.21	+56 percent

1970 and 1975 FORD MUSTANG 2-DOOR

*Cost of fixing front-end collision of 1970 Ford Mustang 2-door in 1970, and cost of fixing 1975 Ford Mustang 2-door in 1975. Damage is to fender, bumper, grille, hood, headlamp, radiator, windshield, fan, and waterpump.

	1970 MUSTANG	1975 MUSTANG	PERCENT INCREASE 1970-75
Parts	\$ 698.30	\$1,005.10	+44 percent
Labor	215.00 (27.1 hours @ \$8 per hour)	273.00 (27.3 hours @ \$10 per hour)	+26 percent
Total	913.30	1,278.10	
Tax (4 percent)	21.50	40.56	
* Total cost of repairs	\$ 934.80	\$1,318.66	+44 percent

1970 and 1975 PONTIAC CATALINA 2-DOOR

*Cost of fixing front-end collision of 1970 Pontiac Catalina 2-door in 1970, and cost of fixing 1975 Pontiac Catalina 2-door in 1975. Damage is to fender, bumper, grille, hood, headlamp, radiator, windshield, fan and waterpump.

	1970 PONTIAC CATALINA	1975 PONTIAC CATALINA	PERCENT INCREASE 1970-75
Parts	\$ 780.50	\$1,174.05	+47 percent
Labor	157.00 (19.7 hours @ \$8 per hour)	190.00 (19.0 hours @ \$10 per hour)	+26 percent
Total	937.50	1,373.05	
Tax (4 percent)	28.82	42.95	
* Total cost of repairs	\$ 966.32	\$1,416.20	+44 percent

Source: American Mutual Insurance Alliance, "Journal of American Insurance," Spring, 1975.

Appendix IX

CASE STUDY: JAPAN'S INFLATION AND ITS ANTI-INFLATION MEASURES

1. Price Movement until March, 1975

Japan's consumer prices, which had been stabilized comparatively after the end of the Korean War, have begun to show a continuous rising of nearly 6% per annum since 1960. This trend was due mainly to the rise in prices of agricultural, marine and livestock products, prices of industrial products produced by minor manufacturers and service charges, all caused by the wage hike resulting from the excessive demand for labor. There has been a rapid rise in prices of materials such as logs and lumber, sugar, soya beans, maize, raw cotton and wool, on the import of which Japan's economy largely depends, since the latter half of 1972. As a result, the consumer prices rose as high as 13.8% during the period from January to October, 1973.

At the very period occurred the oil crisis. Its influence was exceedingly serious, because Japan is utilising large quantities of petroleum as materials for various chemical products as well as the source of energy and almost all of its supply must be imported from abroad. Both enterprises and consumers entertained a strong fear from the feeling of shortage and expected price rising relating to a large number of commodities, and endeavored to secure them as early and extensively as possible, resulting in an extraordinary expansion of demands. In consequence, the consumer prices showed an abnormal rise of 12.9% during only four months from November, 1973 to February, 1974, and those in February rose as high as 26.3% as compared with the corresponding month of the previous year.

In the meantime, the Government's price policy having been adopted since the beginning of 1973 began to take effect. At the same time, consumers became not only severer against the easygoing price raising on the side of suppliers but also more prudent in their purchasing attitude. Thus, the chaotic price rise began to show a sign of cooling down in May, 1974. During the period from July to

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October, part of the public utilities charges were increased and the prices of vegetables, raw fish and fruits rose in consequence of long rains and typhoons. But these facts did not affect the prices of other commodities, and prices in general were stabilized again in and after November. The rising ratio of the consumer prices in March, 1975 was only 14.2% over the corresponding period of last year. Thus, the aim of the Government's first-round price policy intending to reduce the rising ratio to less than 15% was accomplished.

(Note) A turmoil of commodities shortage which began with the oil crisis, and the following development of affairs should be noted as an instance of how gravely the movement of demands affects price fluctuations. The panic began with toilet paper and expanded to cleanser, sugar and so on. A large number of people hastened purchasing and hoarding for fear of the disappearance of these necessities, resulting in a remarkable increase in the purchase quantities of these items. During this period, the prices of all these items rose largely, though different in degree. After the end of this turmoil, the demands for these commodities declined rapidly and prices showed a trend toward stabilization or lowering. From this confusion consumers learned that moderate purchasing would contribute largely to the price stabilization, and began to act on the sound judgment formed by confirmative information. The present price stability owes very much to their saving in consumption.

2. Government's Price Policy

(1) Control of Aggregate Demands

The greatest factor in the extraordinary price rise in 1973, was the increase in the aggregate demands such as private plant and equipment investments, fiscal outlay and consumption, far beyond the capability of supply of all economy. Accordingly, the Government's price policy during this period was based on the control of the aggregate demands. For this purpose the tight money policy was executed strongly both in the financial and fiscal aspects.

DX-3

In the financial sector, the official discount rate was raised five times during 1973 by 4.75% in total, reaching 9% at the end of the year. Particularly, the fifth-round raise enforced in December was as high as 2%. This high raising aimed at the control of the aggregate demands in two aspects: the suppression of speculative movements in anticipation of price spiral which may continue further even after the passing of the oil crisis; and the increase and encouragement of savings by way of the raise of deposit rates. The official discount rate mentioned above maintained its high level until April, 1975, and, linked with this, the deposit rates were also raised. The reserve requirement ratio of the financial institutions, which are required by regulations to deposit a fixed percentage of their own deposits in the central bank, was raised from 1.5% to 7.25% at the end of 1973 through five-time raising during the year. At the same time, the quantitative tight money policy such as the control of the over-loaned situation seen in the financial field was also adopted. Further, the following two temporary measures were taken to suppress consumption by absorbing individuals' funds:

- a. The interest rate of the six-month time deposit was raised at the bonus season by 1% higher than the usual rate. (In Japan there is a custom that an allowance equivalent to four-to-six-month salaries in total is given usually in June and December besides the monthly pay.)
- b. The "Law Relating to Savings with Premiums" was enacted as a law in force only for two years, applying to the time deposit and the saving-linked and usual endowment insurances. Under this law the depositors and policy holders belonging to these categories are given a drawing right, and those having drawn a winning number are paid a premium of ¥10 million for the first prize and so on, the resources of which payment are deposit interests or dividends to policy holders. This scheme was executed by the deposit-receiving financial institutions such as banks, credit associations, co-operative associations and post offices, and also by life insurance companies, agricultural co-operative insurance organizations and the post office life insurance managed by the Government.

IX-4

In the fiscal field, the time of execution of the public investments scheduled for the first half of fiscal 1973 was re-considered in April, 1973, while the fiscal outlay relating mainly to public works projected by the State and the local authorities, more than \$1,040,000 million in amount, was postponed in August, 1973. In fiscal 1974, too, the general account budget and the program for the treasury investments and loans were compiled placing emphasis on the price stabilization, and were executed accordingly.

(2) Price Control and Supply/Demand Adjustment

At the time of the price spiral this time, it was necessary for the Government to adopt the measures stabilizing prices and supply/demand of individual commodities, in order to prevent enterprises' speculative actions such as cornering and hoarding commodities, or their price raise taking advantage of the situation or in anticipation for the future rise, and also to cool down consumers' hasty buying and hoarding.

From such a point of view, the Government had taken such administrative measures as emergency import and the release of the Governments' stock in respect of the price rising commodities since 1972. Further, the "Law Relating to Emergency Measures for Cornering and Hoarding Commodities Connected with Daily Living, etc." ("Cornering, etc. Prevention Law") was established in July, 1973, and the "Law of Emergency Measures for National Life Stabilization" and the "Law Rationalizing Supply and Demand of Petroleum" in December of the year.

The "Cornering, etc. Prevention Law" aims at the price stabilization and the security of supply of specified commodities. Under the-law, the Government may designate such items connected with daily life as likely to be cornered or hoarded; it surveys and watches prices and supply/demand of those items; if it has found producers, distributors or importers who hoard large quantities of those items, it may direct them to release, or order them to sell, those commodities. Those so designated covered 24 items including soya beans, cotton yarn, kerosene, toilet paper and liquid petroleum gas.

IX-5

The "Law of Emergency Measures for National Life Stabilization" aims at the stabilization of national life. Under the law, in the event of prices of commodities important to national life rising or being feared for rising, the Government may designate such commodities and take, according to the situation, such measures as the establishment of the standard prices, the collection of surcharges and the direction of production and importation, in respect of the designated commodities. In January and February, 1974 four items, kerosene and liquid petroleum gas for domestic use, tissue paper and toilet paper, were designated, and their standard prices were established.

The object of the "Law Rationalizing Supply and Demand of Petroleum" is the rationalization of supply and demand of petroleum (crude oil and petroleum products) by way of securing their proper supply and reducing their consumption.

In March, 1974 a sharp rise in the import prices of crude oil brought about the upward revision of prices of the domestic petroleum products. At this time the Government requested the enterprises concerned to restrain price raise in respect to 53 items (6 items added on April 1) and guided them to the prior approval of the authorities concerned in case of price raising. Further, for the purpose of price stabilization on the distribution stages, the Government requested general trading companies, department stores and supermarkets to refrain price raise in respect of daily necessities, clothing items, etc.

The regulations under these laws, however, were gradually relaxed in accordance with the subsequent improvement of supply/demand situations. Since May, 1974, the standard prices established for tissue paper, toilet paper and kerosene for domestic use have been abolished, and ten items including raw silk have been removed from the commodities designated under the "Cornering, etc. Prevention Law". Further, the commodities designated under the authorities prior-approval system were gradually reduced, and the designation was all removed by the end of September.

IX-6

(3) Restraint of Public Utilities Charges

Public utilities charges were restrained as far as possible in line with the suppression of price rise of commodities. The upward revision of the Japanese National Railways fares and freight and of the Government's selling price of rice was decided, at the end of 1973, to be postponed six months from the date previously scheduled. In view of a sign of the price hike slowing down, electric power rates, private railways fares and freight and municipal traffic fares have successingly been raised since June, 1974, but only to a minimum. The raise of prices, however, of salt, wheat, barley and postal charges was shelved. In the compilation of the budget for fiscal 1975, the charges for telegraph and telephone were also decided to be frozen during the fiscal year.

(4) Other Countermeasures

In addition to these price policies, to rationalize the conditions of competition a severe control was conducted over the price agreement and the re-sale price maintenance system (the system under which the makers fix the retail prices of their products and let their retailers keep these prices) violating the "Antimonopoly Law". Besides, for the purpose of the rationalization of distribution and the modernization of less productive sectors, a long-term and structural price policy was adopted by way of the expansion of various measures then existing.

3. Deepening Stagnation and Recent Price Movement

The execution of the price policies mentioned above was effective for cooling-down of prices, but it brought about the stagnation of economic activities, the worsened business results of enterprises and an increase in unemployment. (The unemployment ratio increased from 1.4% in 1973 to 2.2% in March, 1975.) Thus, Japan registered a minus economic growth rate in real terms in 1974 for the first time after the war. And the peg of public utilities charges expanded the deficit of public utilities, while a decrease in tax revenues invited such a serious problem as financial difficulties of the State and local authorities.

IX-7

On the other side, the consumer prices showed continuously the trend of cooling-down in and after April and registered in July an increase of 11.4% over the corresponding month of last year. This was partly to the fact that the wage increase in spring of this year was suppressed to a low level of 13% in average over last year (32.9% in 1974), influenced by the strong attitude of the management suffering from the worsened business results. In consequence, public utilities charges having hitherto been pegged are expected to be raised, and there remains a strong feeling of inflation under the pressure of the cost-push price rising. In a word, the situation does not necessarily allow an optimistic view. Nevertheless, it is widely expected that the Government's second-round price suppression target, which aims at reducing, by the end of March, 1976, the increase ratio of the consumer prices to one-figure percent over last fiscal year, will be attained within this year.

In these circumstances, the Government has gradually begun to slacken finance, though still giving priority to the price policy. Thus, the Government lowered the official discount rate by 0.5% each in April, June and August, 1975 respectively, and decided to execute collectively the contracts for public works in the first half of this fiscal year. These measures, however, were not very effective. The effective opening-to-application ratio in July was 0.56 time, the lowest level since December, 1965, while the number of insolvencies of enterprises was still on a high level. Thus, the economic situation has become severer and severer. In view of this situation, the Government is now studying such reflation measures as: the fourth-round reduction of the official discount rate; the reduction of the reserve requirement ratio which has been pegged to the level at the end of 1974; the flexible operation of the regulation regarding banks' over-loan; the additional public works outlay amounting to about ¥2,000,000 million in the latter half of this fiscal year by a supplementary budget.

The CHAIRMAN. Gentlemen, thank you very much. The last two witnesses obviously speak as a minority, but you speak with considerable conviction and, of course, the obvious first question is how could you explain the fact that so few others in the insurance business seem to agree with you? Mr. Hiestand, first you say, "We believe Congress should move to deregulate insurance pricing. The need and the public benefits are clear." You go on to say, "If States no longer need to direct their attention to rate regulation, they will be able to be more vigilant and creative in their efforts to prevent insolvencies or to reduce their impact."

Now that is, if not a lone voice, is one of the few who have called for that. We had, for instance, Mr. Stone, the very able insurance commissioner in Massachusetts who supported part of the bill enthusiastically, but he said—he made an interesting argument yesterday that rate competition among insurers "is not, and may never be, sufficient to assure an equitable rate structure." He believes that competitive rating systems discriminate against and even shut out certain groups unnecessarily; for instance, he says that inner city residents bear the burden of high rates, even though many city accidents are caused by commuters whose rates are lower.

You place so much emphasis on that and we had impassioned testimony from other witnesses in addition to Mr. Stone who argued that this would just be the destruction of the small insurance companies, that they just didn't have the capacity to price on any sound basis if they didn't have the rating systems that the States now provide.

Mr. HIESTAND. Senator, I'm afraid that we have to disagree with Commissioner Stone on that score. We devote a lot of space in our statement to analyzing the structure of the insurance market, quoting the Department of Justice report and other studies made by these prestigious insurance departments which in effect say competition does work. It is working. As the New York Insurance Department said in its February 1977 report, competition is working better than the prior approval worked there, and in the opinion of the commissioner their rates were probably lower under the competitive rating system.

The CHAIRMAN. They may be lower and they may work in that sense. Perhaps for a while you would get a lower premium for the insured public, but at the same time, wouldn't you in the long run tend to eliminate many of the small insurance firms that do provide competition overall and more options and certainly an opportunity for these insurance companies to grow and develop and to provide jobs?

Mr. HIESTAND. I don't believe so, Senator. We don't believe that the well-run small companies will be disadvantaged by an approach of this nature. Over the years, some of our most vigorous competition has come from small companies.

The CHAIRMAN. It comes now because they have a system of being able to have their prices established on a sound basis, but how does a small company go about this if it is competing with an organization as big as yours? Is it just whatever price you set? Does it provide the same price or try to provide a lower price?

Mr. HIESTAND. Well, in the first place, our proposal would permit loss costing or loss costs to be compiled so that the companies can draw

on that. Our experience in Illinois wherein we have had a competitive rating system since 1971 and no rating law whatsoever since shortly thereafter is that the small companies are getting along there. I made a speech about a year ago to the National Association of Mutual Insurance Cos., most of whom are small local companies. In preparation for that speech which was on this subject, I talked to a lot of people in Illinois who are with small companies, and though my survey was admittedly very nonscientific, I did not find anybody who complained of difficulties that they were having.

I made this statement during that convention, and somebody in the audience stood up and said, "I'm with a small company in Illinois," and I sort of held my breath, and he said, "You're absolutely right. We're getting along fine."

The CHAIRMAN. Mr. Douds, how would you answer that?

Mr. DOUDS. Well, first, in the life side of the business, as far as we are concerned, we don't have the particular problem with pricing because there is open competition among the companies and rates are not regulated. So we have, we think, in that phase of the business, adequate competition as far as rates are concerned.

The CHAIRMAN. Let me ask Mr. Pierce. You were the one that raised this issue during the testimony here.

Mr. PEARCE. Well, I have no qualms about the fact that open rating may be successful in Illinois, but I would suggest that the rates used by the small companies are in fact bigger. In concert with other small companies the loss costs and the expense data is gathered by a bureau. The trending functions are done by the bureau. The companies then receive the rate that comes out of this concert and these are the rates that are used. This way they get a larger sample.

In statistics, of course, we always were taught the larger the sample, the more credibility to the data, and the small companies are able to compete in the open rating States because of that. The removal of the antitrust immunity, however, would then remove the rights of the companies to have the trending function done by a bureau.

The CHAIRMAN. Wouldn't they still have access to the figures?

Mr. PEARCE. They could. I believe under the antitrust laws they would be able to gather the data necessary to arrive at the lost costs. I don't think the trending functions and the profit factors could be done for them by a bureau that would be part of the insurance industry. They would have to go out and buy this.

The CHAIRMAN. Not being involved in insurance and knowing very little about it and asking your objective advice, it just seems so logical from Mr. Hiestand's position that the concern the States should have would be to prevent insolvency and protect the policyholder from a bankrupt insurance firm. At the same time, it's very attractive to me and I think it would be to other Senators to provide a system where you can have vigorous competition, as vigorous as possible, and the only kind of competition that we usually think of is price competition.

You don't have that now and Mr. Hiestand says that you should have.

Mr. PEARCE. I think we do have.

The CHAIRMAN. On price?

Mr. PEARCE. Because the evidence of the growth of the companies like Mr. Hiestand's company and some of the others who operate

would indicate that in spite of the fact that the insurance rating is done in concert, the competition is there and those who do have sufficient credible data base to arrive at their own rates can use those rates and in fact obviously this accounts for some of the growth of these companies.

I think the competition is there now without putting the smaller companies to the extra expense of doing their own or buying the trending functions necessary to come out with the final rate.

The CHAIRMAN. I would like to ask Mr. Reinmuth's view of this. You pointed out that while you're a small company, I think most people would argue that any outfit that provides over \$5 billion of anything, including life insurance, isn't tiny, and that you're among the largest automobile insurers in Michigan with 100,000 motor vehicles insured, and you say, "We believe that enactment of S. 1710 would represent a breakthrough for insurance regulation and that such a law would provide significant protection and benefit to the insurance consumer."

Mr. REINMUTH. Yes; and I also should say we believe in competition. We don't really see the problem that's being alluded to here. Particularly, we feel confident that we can determine our own expense and profit levels. Collection of loss data, that's a different matter; but with respect to any small company, they ought to be able to figure out what their expenses are and what kind of money they want to make. So we don't see that as being a substantive issue.

The CHAIRMAN. Mr. Pearce and Mr. Kremer, you both appear to believe strongly that permitting Federal chartering of insurance companies and removing rate regulation of the antitrust exemption would put smaller companies at a competitive disadvantage in relation to larger, presumably federally chartered, companies and might even put some small companies out of business.

This implies that the smaller, more local companies tend to be less financially sound and they can only compete if their rates are kept high through State regulation.

Mr. Hiestand has indicated that large national insurers such as State Farm, experience the most vigorous price competition from small, locally managed companies operating in local markets. What's your response? Are small companies competitive?

Mr. KREMER. Yes; I think they are. They compete very favorably today and I can tell you that being an independent agent in Maryland there is intense competition for personal lines insurance.

The CHAIRMAN. Then why do we need the protection of an antitrust exemption for the industry?

Mr. KREMER. I think our concern is that we would set out two classes and that the public might perceive that the smaller companies would be less financially sound and that the policies might not be acceptable in certain lending institutions and things like that if they were not part of the Federal guarantee program.

The CHAIRMAN. I don't understand. You say they might perceive. Why would this change their perception?

Mr. KREMER. Well, I think I can conceive of situations where the policyholders would say to the producer, "I understand that some companies are guaranteed by the Federal Government like FDIC or

FSLIC, and I want to be with one of those companies. I don't trust the little companies that aren't part of that Federal program."

The CHAIRMAN. They may be guaranteed by the State. They would be guaranteed in many cases by the State.

Mr. KREMER. That's true, but I still think the buying public—

The CHAIRMAN. In my State most of the constituents I know would just as soon trust the State of Wisconsin as the Federal Government—in fact, more so.

Mr. KREMER. That's probably very true, sir, but I do think that is a serious concern that people would look at it and say all of the Federal treasury is backing up this insurance and not that insurance company.

The CHAIRMAN. You say the Federal chartering would give that impression?

Mr. KREMER. Yes, sir. I think it would give the impression of two classes of companies.

The CHAIRMAN. Mr. Doubs, you make an interesting point about the language in S. 1710 which would permit federally chartered insurers to "conduct any other business which is complementary or incidental to the insurance business or the functions performed therein." You are correct in noting this committee's concern about the effect of similar language in encouraging entry into nonbanking activities by banking holding companies under the Bank Holding Company Act, and I think that was a very useful point. We know how vague and how frustrated we have been in the enforcement of that vague language.

What other lines of business do you think federally chartered insurers would attempt to go into under this language, and do you have any suggestions regarding the "laundry list" of permissible activities you say an amended bill should include?

Mr. DOUBS. Well, Mr. Chairman, I guess the human imagination would be the only boundary on the kinds of businesses that some insurance companies, or any other commercial companies for that matter, might want to go into if they had the authority to do so, and this was our main concern.

As the economist from the Fed in Chicago who wrote that article in "Economic Perspective" pointed out, the cause seems to be the vagueness of the legislative language. So our concern is that no matter what industry it is, if the language is this vague somebody within that industry will be tempted to get into far-fetched businesses.

The CHAIRMAN. I'm inclined to go along with you in view of our experience in the Bank Holding Company Act because they have gotten into some areas that banks obviously shouldn't be in. They don't have the expertise but they have the capital power and position to, in my view, compete very unfairly, including competing in your business.

Mr. DOUBS. Yes.

The CHAIRMAN. So I think that's a good point. Well, what you do, though, is simply, as far as that particular point is concerned, make that language express and explicit rather than vague as it is here?

Mr. DOUBS. I would really nail it down, Mr. Chairman, because we can see a lot of trouble for the future if we don't.

The CHAIRMAN. Mr. Hiestand, can you describe to the committee any insurance-related activities which a large company like State Farm might plan to engage in if it were granted such authority under Federal chartering?

Mr. HIESTAND. I haven't given the subject much thought, Mr. Chairman. When Mr. Douds read his statement it occurred to me that there are holding companies in the property and casualty and life insurance area and that these holding companies through related enterprises are engaging in a great variety of activities.

State Farm attempts to limit its activities to matters related to the insurance product, to furnish related services, for example, assist our customers in locating automobile financing. We assist them in situations—

The CHAIRMAN. But you don't engage in automobile financing?

Mr. HIESTAND. No, sir.

The CHAIRMAN. Go right ahead. I didn't mean to interrupt you.

Mr. HIESTAND. Well, we have a program whereby our policyholders who travel in Mexico, for example, who need to obtain that coverage, we have a related—

The CHAIRMAN. Are you getting into the travel agency business?

Mr. HIESTAND. Not precisely, but we see to it they will get coverage that will protect them in Mexico and that can be a problem. But to answer your question, we do not engage in a wide range of variety of activities. We have a couple mutual funds to go along with the financial services we offer and that's about it.

But other companies, if you examine the related activities of those companies, I would suppose you could find a variety of things.

The CHAIRMAN. Wouldn't you agree with Mr. Douds, however, that we ought to be a little more explicit here and nail down the kind of activities in which companies can engage?

Mr. HIESTAND. Yes, sir. I think that makes sense. At least it makes sense to be certain that funds which are needed to protect policyholders aren't diverted to nonrelated activities. There was an insolvency in Texas a while back in which the company went broke because its holding company pulled out most of its good assets and channeled them into finance factoring and when finance factoring went sour the insurance company went insolvent. There needs to be protection against this kind of thing.

The CHAIRMAN. Mr. Reinmuth, your statement gives a number of interesting suggestions about ways to guard against discrimination in provision of rating of insurance under a proposed Federal chartering system. I'm talking about the memorandum which you attached to the letter you sent us.

Would you describe these ideas briefly to the committee and tell us if the League Insurance Group has taken any steps toward developing innovative rating systems?

Mr. REINMUTH. Basically, it relates to the point I think that was raised earlier about the problems of proliferation of classifications and these classifications are not really supported by any objective data. So we were suggesting that some attention be given to that area and at this point the—

The CHAIRMAN. Let me just interrupt to say that, by and large, we think the insurance business has done an excellent job and I greatly admire what they have provided, but I do think the one area where we get complaints from consumers is that there is discrimination—maybe it's justified—against young men who want insurance in driving cars and sometimes against women and sometimes against people with low incomes and so forth, and this is the kind of thing that you seem to address.

Mr. REINMUTH. Yes. This is the very problem we are trying to address. The problem is that it relates to the availability of insurance which cannot be ignored in this whole area, and Michigan is now considering legislation—it's just really been introduced—to try and address that problem by requiring companies to be a little more objective in their development of their ratemaking classifications.

The CHAIRMAN. In other words, you don't object to the fact that they do have higher rates?

Mr. REINMUTH. Oh, no.

The CHAIRMAN. For higher risks. They have to do that. That's sensible. What you object to is that some of these rates don't seem to be based on any kind of logical actuarial fact?

Mr. REINMUTH. Exactly, and that's why we think that it's very, very important from the consumer point of view that they be based on fact and on good empirical evidence.

As far as our own company, I suspect we have had some actuaries look at it because we know the problem is there.

The CHAIRMAN. Could an antidiscrimination law take care of the problem under a competitive rating system?

Mr. REINMUTH. Partially I think. That's what we tried to say. It would partially solve the problem but we still may run into some problems with respect to assuring availability to people, particularly in the issuance of insurance, but I think it goes part way toward addressing that problem.

The CHAIRMAN. How would you deal with that problem?

Mr. REINMUTH. The answer to that is complex.

The CHAIRMAN. You might think about this and then for the record when you correct your remarks in the next couple days you might give us what answer you can.

Mr. REINMUTH. Yes. We believe that a reinsurance facility at the State level combined with these antidiscrimination statutes will be an effective way to handle the availability problem. I don't think a national reinsurance facility is feasible within the context of the voluntary charter concept. However, we think that for federally chartered insurers you must have a fairly stiff antidiscrimination provision so you don't get into the problem that you were mentioning.

The CHAIRMAN. Senator Brooke.

Senator BROOKE. Thank you, Mr. Chairman.

Mr. Pearce, you state that smaller companies, if they chose Federal charters, would incur additional costs which they do not now incur. S. 1710 does not require such companies to become federally chartered, of course.

Now I recognize your concern that larger insurers, if they became federally chartered, might not participate in bureau development

of loss and expense data. Why do you really think this would happen, particularly if the law made clear that participation in such data bureaus so long as it did not involve ratemaking would not be a violation of the antitrust laws?

Mr. PEARCE. I believe I said that the gathering of loss data and expense data relevant to losses would not be in violation of the antitrust laws. What I said was that the additional factors that are then introduced into the rate would have to be done by the individual companies, many of whom are too small to have their own actuarial staffs. They would have to go out and purchase that operation from a contractor which would then result in additional costs.

It is our opinion that the present method of gathering the loss data facts, putting the trending functions on to it, the profit factors on to it, by a bureau for a great many companies reduces the cost to each company substantially. We think that when these companies have to go out and purchase this additional operation individually that it will increase the cost to the smaller companies to the extent that they quite possibly could price themselves out of the market in competition with big companies who are large and able to have their own actuarial staffs and do all of these factors within their own staff.

Senator BROOKE. But these large companies do have a need to pool data regarding certain lines of insurance, and I understood you to say that the large companies may not participate.

Mr. PEARCE. No; the ultimate final rate the large companies can charge will be, in our opinion, at an advantage over the smaller companies because they will be able to have the actuarial staffs within their own organizations to do that. I'm sure that there will be a sufficient amount of loss data that will be gathered by a bureau that will include many of the large companies as well as many of the small companies in arriving at the loss data; but beyond that is where the difference in cost occurs.

Senator BROOKE. Would you agree, Mr. Hiestand?

Mr. HIESTAND. Senator, I do agree with Mr. Reinmuth that there's no need, in our opinion, for companies who do pool obtained loss data to sit down together and pitch their expenses in, average them out, then decide among themselves what they believe the trend factors are going to be and thereby arrive at an agreed upon rate. We believe, as Mr. Reinmuth stated, that every company should know its own expenses and as far as obtaining advice concerning trend factoring, and so forth. There are many excellent consulting actuarial firms and I have no doubt that they will offer services and I doubt very much that they would be unduly expensive. We do not see this as a problem to small companies.

Senator BROOKE. Thank you. Gentlemen, some of you and some other witnesses have raised the specter that while at first there may be no rate regulation at the Federal level, there would soon be pressures to establish a rigorous scheme of Federal rate regulation; that's the fear.

Now even if open competition doesn't work well for federally chartered insurers, isn't it much more likely that the Federal Government would cede rate regulation back to the States rather than set up a new Federal rate regulatory system?

Mr. Douds, do you want to tackle that?

Mr. DOWD. Well, Senator, I couldn't comment on the property-casualty aspect of it, but in life insurance, as we mentioned before, there's no rate regulation now at the State level and even in the Justice Department report I don't believe rate regulation is advocated for life insurance. I think they feel that the way the rates are made now is sufficient.

So from our standpoint, representing life insurance field people, we would not see any specter of Federal rate regulation of life insurance in S. 1710.

Senator BROOKE. Mr. Hiestand?

Mr. HIESTAND. We would certainly hope that there would be no such vacuum, as I believe Commissioner Kinder called it, which would cause the Federal Government to move into the rate regulatory area. We have constantly advocated the antitrust law approach and been against a Federal regulator of insurance rates. We are occasionally misquoted, but our position very much involves only the antitrust law. It seems to us that statements made by various people in this administration and the last indicate that the thinking in Washington is going in the opposite direction, that there's a recognition that there can be too much interference with business and that there would hopefully be little or no disposition to set up a Federal regulatory structure.

Finally, we are confident that competition will work in the industry. From all the indications, we have little concentration in the industry itself. We think it's going to work and we are confident that no vacuum such as alluded to is involved.

Mr. KREMER. I think, Senator, our feeling is that the vacuum is made to order for the bureaucracy and we cannot envision that they would not rush in to put Federal rate regulation, at least of automobile insurance, just as soon as we had Federal legislation.

Senator BROOKE. Why would they rush in?

Mr. KREMER. I just think it's their nature. I think that automobile insurance, sir, is not something that the consumer wants to buy. It's mandatory now. And to have open competition in those conditions I think is just an invitation to Federal ratemaking, particularly, as I say, in the automobile field.

Senator BROOKE. Well, that certainly is not the intent of S. 1710. I'm sure you recognize that.

Mr. KREMER. Yes, we do, sir.

Senator BROOKE. And I obviously would disagree that that would happen.

[The following letter was ordered inserted in the record:]

INDEPENDENT INSURANCE AGENTS OF AMERICA, INC.,
New York, N.Y., September 16, 1977.

HON. WILLIAM PROXMIRE,
Dirksen Senate Office Building,
Washington, D.C.

DEAR SENATOR PROXMIRE: I would like to supplement the oral remarks I made in response to a question by Senator Brooke and ask that this letter be included along with my testimony in the record of the Committee hearings. During questioning, Senator Brooke asked me to amplify on the reasons for our association's belief that the enactment of his bill would lead in time to the federal regulation of insurance rates. Events on both the state and federal levels convince us that this result would occur even though Senator Brooke has made it clear that he does not intend such a result and that one of his central objectives is to pro-

vide those companies which opt for a federal charter substantial freedom from rate regulation.

Strong political pressures to contain increasing insurance costs, especially for lines which consumers are required to buy, are currently being felt in many states and have resulted in decisions that restrict free pricing. The most graphic example of this is the recent decision of Commissioner Stone of Massachusetts to use his authority to rescind the competitive rating law for automobile insurance and substitute a prior approval law. We believe this decision conflicts with recent reports by the New York and Illinois Insurance Departments¹ which have indicated that competitive rating laws have resulted in a better price for the consumer and a more available market.

Federal legislators are at least as accessible to their constituents and to interest groups as state legislators and regulators are, and we fear that these political pressures would have the same effect on the federal level.

A number of federal developments this year confirm our fear that the promise of freedom from rate regulation would be short-lived. The most striking example is the Holtzman Amendment to the Housing and Community Development Act of 1977 (H.R. 8655) which, if enacted as originally drafted, would have provided for the federal regulation of rates charged in the Fair Plan Program. This program was set up to provide property insurance coverage for high risks, particularly in urban areas, but it specifically left the regulation of Fair Plans, including rates, to the states. The Holtzman Amendment would have required that Fair Plan business be written at the advisory rate level for business in the voluntary market and that before an increase in rate could be charged, application would have to be made to the Federal Insurance Administrator showing "extraordinary need." Even if this need were shown, the maximum permissible increase in rate would be 30% above the advisory rate. Passage of this amendment would have had (and would still have as currently amended) the most unfair result of forcing risks in the voluntary market to subsidize higher risks in the Fair Plan.

While no such amendment has yet been introduced, we have been told that some legislators are already talking about some type of rating control in the federal no-fault standards bill for automobile insurance under consideration.

Another disturbing example that federal programs do not always proceed as originally intended is the national flood insurance program. This program was set up as a cooperative partnership venture between the federal government and private industry and proceeded relatively smoothly in this manner for over eight years. However, this year, as a result of differences the parties have not been able to resolve, the Department of Housing and Urban Development has proposed regulations which would assert the dominance of the Federal Government over the program and would convert the program from an industry-government partnership where industry is a risk bearing partner, acts as a private insurer, and operates the insurance aspects of the program, to a one-sided government insurance program, where the federal government bears all the risk and federal government employees make the operational decisions.

Mr. Brooke also suggested in the hearings that before the federal government would invoke federal rate regulation, it would return regulation to the states. We believe this is extremely unlikely to happen. First, constituents would demand relief from their federal legislators and would not be satisfied if the problem were passed back to the states. Second, once the federal government takes over the regulation of a large segment of the insurance business, the states will pare down their operations and will no longer be in a position to handle a transfer of regulation back to the states.

It is for these reasons that we believe that the passage of Senator Brooke's bill inevitably would lead to federal rate regulation. Thank you for this further opportunity to express the views of the Independent Insurance Agents of America, Inc.

Respectfully submitted.

HOWARD J. KERNAN,
Chairman, IIAA Federal Affairs Committee.

¹ State of New York Insurance Department, "The Open Rating Law and Property-Liability Insurance—An Evaluation of Insurance Price Regulation," February 1977.
State of Illinois Department of Insurance, "Illinois Automobile Insurance Rate Study," May 1977.

Senator BROOKE. Mr. Douds, you make a number of very good points, among them your concern about removal of federally chartered companies from the operation of State retaliatory taxes. But since federally chartered companies will not be chartered in any State, why should they be held responsible for the rate increases which may occur in any State?

Mr. DOUDS. Tax rate increases?

Senator BROOKE. Yes.

Mr. DOUDS. Well, I don't know that they necessarily should be, but I'm not sure that that's our point. You're looking at S. 1710 as being primarily a measure to protect against insurance company insolvencies, so first of all, unless somehow State premium taxes have led to insolvencies, then we wonder why S. 1710 should deal with State premium taxes at all, and if it should deal with taxes in some way, then why should it prevent the retaliatory tax?

Senator BROOKE. It doesn't deal with the State taxes. We don't attempt to get into State taxes. There's nothing in S. 1710—nothing intended to be in S. 1710 that would do that. But we do address in S. 1710 the example you gave before of an insurance company in Maine doing business in New York, say, which would not be subjected to any discriminatory tax. That's the only thing we were trying to get at.

Mr. DOUDS. We are concerned with the language of the section. Despite Mr. Buckley and others' attempts to explain it to me, I just can't get it through my head, because it says that no State could tax a foreign company any more than it taxes the least taxed foreign company doing business in any State—not that State, but any State.

Senator BROOKE. Doing business in that State, not doing business in any State.

Mr. DOUDS. But, Senator, that's not what it says. It says doing business in any State.

Senator BROOKE. All right. We will look at the language. I appreciate you pointing that out, but I wanted to clarify at least my thinking on that at any rate. We'll look at that.

Mr. DOUDS. I appreciate that.

Senator BROOKE. Mr. Reinmuth, you mentioned there's a system of dual regulation of insurance companies in Canada. How has this system worked? Have Canadian companies found the dual system to be burdensome or unworkable?

Mr. REINMUTH. Well, I'd have to say that we are not licensed in Canada so we can't really give firsthand knowledge of it.

On the other hand, I am aware that quite a few American companies do have affiliates in Canada and I have never heard or read major criticism of the Canadian system in terms that it was anticompetitive or had any major problems regarding solvency. I'm not aware they have an insolvency fund system at the national level. But, no, I have never heard much substantive criticism of the Canadian system.

Senator BROOKE. Mr. Chairman, again, first let me thank the panel and express my sympathies to your general counsel, Mr. Hiestand, and your general counsel, Mr. Reinmuth, for the bad run on general counsels. It's also a bad run for me because I understand both of them were

most sympathetic to S. 1710, and I have had my own problems with attendance, so I trust that both of them will recover shortly.

I want to thank this panel, as I have thanked other panels, because we have had, I think, an exceptional group of witnesses that have appeared before us.

Mr. Chairman, you raised at the beginning of this hearing and you have raised on several occasions a key question, and that question, of course, is: Why the necessity for federally chartered insurance companies or dual insurance system as I refer to it?

I want to thank you, again, for calling these hearings. I want to also thank you for your very objective and very excellent questioning of all of the witnesses. I must say that I'm pleased but certainly not surprised. It's customary for you. I think these hearings have been most helpful, as I have said, and despite the fact that this bill has, I think it's fair to say, not met with universal acclaim, I remain convinced that there are major weaknesses in our present system for preventing and dealing with insurance company insolvencies and I remain convinced that S. 1710 or a modified version, as some of you have suggested, could make a major improvement in our present system of solvency regulation. That was my primary concern and it's still my primary concern. I think it's a concern of many insurance companies as well as policyholders around this country. We have had some evidence that there are some problems with which we have to deal and I, too, agree with the chairman that the insurance industry has done an exceptionally good job. I'm not looking for areas of Federal bureaucracy or Federal control or Federal regulation. I sit on the right side of Mr. Proxmire, not on the left side of Mr. Proxmire.

The CHAIRMAN. Only physically. Not fiscally, but physically.

[Laughter.]

Senator BROOKE. Despite my liberal bent in some areas, I certainly am a conservative where it comes to the free enterprise system. I agree very strongly that this is a great and major industry in our country and I respect it. Where there's need for improvement, I'm sure the industry benefits from that improvement as well. That was my purpose, and as I said, when I first introduced this legislation last year I knew it would take time to look at it. I threw it into the ring because I wanted the industry to do exactly what the industry has done—make recommendations and point out the weaknesses not only in the legislation but even with the concept itself.

So, Mr. Chairman, because we haven't universal acclaim, as I said, I'm not going to move or ask you for a markup of this legislation this year, but this certainly does not mean that the issue will be dropped. I intend to continue to focus attention on this issue, to look at the Canadian experience, Mr. Reinmuth, as you have recommended, to address the issues raised by the many excellent witnesses that have appeared before this committee, and to work on improving S. 1710 and, as I said, though my head is bloodied, it's not unbowed, and as Gregory Peck said, "I shall return."

The CHAIRMAN. Senator Brooke, I don't think you will ever go away. There are a few who think you should, but not many.

Senator BROOKE. Thank you, Senator.

The CHAIRMAN. I think this has been a very, very helpful set of hearings. The legislation is most thoughtful and constructive. Obviously, there are many aspects of our commercial life that can be improved and insurance is certainly one of them, although, as I say, the insurance companies, we agree, have done a good job, but it's very good to have this kind of proposal so that we have a focus for discussion for improvement.

I think this panel has been an outstandingly good panel, very thoughtful, intelligent presentations. We have had a chance to read the very excellent material that's been submitted to us and, as Senator Brooke has said, this is something we are going to keep after very carefully as the years go by. This committee I think has jurisdiction here, although it's a kind of strange thing because insurance has been outside the reach of the Federal Government. The jurisdictions are not quite as clear as they might be. At any rate, we are certainly going to do our best to work with the insurance industry to develop the most constructive and useful legislation both for them and particularly, of course, for the American consumer. Thank you very much.

The committee will stand adjourned.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

[Additional material received for the record follows:]

STATEMENT ON THE LIFE INSURERS CONFERENCE
ON S. 1710, THE "FEDERAL INSURANCE ACT OF 1977"

The Life Insurers Conference ("LIC") on behalf of its 91 member companies is pleased to have the opportunity to offer comments on S. 1710, known as the Federal Insurance Act of 1977 ("Act"). For the reasons set forth hereinafter, the LIC is strongly opposed to this measure, both in substance and in concept.

The purpose of the Act, according to Senator Edward W. Brooke (R., Mass.), its author, is to protect policyholders against insurance company insolvencies. To this end, the Act establishes a Federal Insurance Guaranty Fund to guarantee the insurance obligations of participating companies. It also creates optional federal chartering for insurance companies, similar to that now allowed for banks under the national bank system. Once an insurer opts for the federal charter, it would be required to participate in the federal guaranty fund while an insurer operating under a state charter could elect such participation. An insurer acquiring a federal charter would be exempt from state guaranty fund requirements, state reserve requirements, state investment limitations, liability for retaliatory taxes and state rate regulations. An insurer under state charter which elects to be a federally guaranteed insurer would be exempt from the provisions of any state insolvency guaranty plan.

The Act vests in the Federal Insurance Administrator the authority to establish reserve requirements, regulate investments and examine the financial affairs of federally chartered insurers.

Insurers not electing to obtain a federal charter or participate in the federal guaranty fund would continue to be subject to state law.

Under the McCarran-Ferguson Act, adopted in 1945, the regulation of insurance by the states is declared by Congress to be in the public interest. The LIC submits that there is absolutely no evidence that state regulation has ceased to serve the public interest. Given the justifiable concern for balancing the federal budget and the tendency of federal agencies to become bureaucratic nightmares, the LIC believes that Congress would be ill-advised to create a federal agency which would displace state control of the insurance industry, in the absence of clear and convincing proof that the states have failed to meet their obligations to protect the interests of policyholders.

In explaining the need for the Act, Senator Brooke cites the tremendous underwriting losses suffered by casualty companies in recent years and speculates that the state guaranty funds might not be able to withstand the failure of a major company. The LIC submits that the record of the state guaranty funds during this period, rather than giving

rise to a need for federal regulation, demonstrates the ability of the states and the companies to deal with insolvency during time of extreme economic hardship. Throughout this period, there was virtually no loss of benefits to policyholders due to insolvencies. As noted by Senator Brooke, state guaranty funds have paid out \$104 million dollars since 1969 to meet the policyholder obligations of insolvent companies, and the outlook for the industry is improved.

A significant development of the state regulatory authorities, through the National Association of Insurance Commissioners ("NAIC"), is the "early warning system", a system for detecting potential financial difficulties of insurers at a time when corrective measures are possible to avoid policyholder losses. This system is now operating in the various states for the protection of policyholders. The Act provides that "the United States national policy shall be to facilitate early detection of the financial condition of insurers" which portend insolvency. The Act recognizes the expertise of the NAIC and its members by authorizing the Federal Insurance Commission to contract with them to establish and maintain its "early warning system." Where is the logic in creating a federal commission to contract for services already being capably provided policyholders by the

very individuals with whom the commission is authorized to contract? Cost and red tape would be increased, while policyholder protection would not be enhanced.

Further evidence of the adequate protection of the interests of policyholders is the state regulation of insurance company investments. These state laws have as their sole aim the continuing ability of insurers to pay claims. The LIC submits that federal regulation of investments could not improve upon the present state safeguards against insolvency. In fact, the Act provides that investments of the federally guaranteed insurers shall be regulated by state investment laws, a further acknowledgement of the capacity of state regulation to protect policyholders against insolvency losses.

Although the Act is proposed for the stated purpose of protecting policyholders against insurance company insolvencies, its passage would likely result in impaired, rather than enhanced, policyholder security. If this measure is adopted, it is reasonable to assume that the companies electing to participate in the Federal Insurance Guaranty Fund would, in large part, include most larger ones with multi-state operations. Since the Act exempts the federally guaranteed insurers from assessments by the state guaranty funds, these state funds would be generally left with the smaller companies, thus undermining the security provided by such funds.

In addition, the Act permits the Federal Insurance Commission to deny participation in the Federal Insurance Guaranty Fund to insurers with inadequate reserves, investments of insufficient integrity and stability, overreaching underwriting commitments and untrustworthy management. These companies with a higher than normal potential of insolvency would thus remain in the state guaranty funds while the financially sound insurers are accepted in the federal fund and exempted from state fund contributions.

The state guaranty funds, therefore, which were formed for the purpose of spreading the risk of insolvency, would find themselves without the financial backing of the companies which control a large portion of the assets of the insurance industry, while at the same time being saddled with many insurers deemed by the Federal Insurance Commission to be prime candidates for insolvency. This result would severely weaken the state funds which Senator Brooks sees as already "fragmented and ineffective", and would leave a significant percentage of the nation's insured persons with less security against insurer insolvencies than is now available.

The LIC submits that the Act would have a deleterious impact upon the skill and proficiency of the state insurance regulatory agencies. The regulation of the large, more complex companies has been a major factor in developing the

present high level of competence in the state regulatory agencies. If and when these large companies opt for a federal charter, it is reasonable to expect a concomitant decrease in the size and effectiveness of state regulatory agencies.

Further, the LIC questions the propriety of the federal chartering provisions in the Act. The stated purpose of this Act is to increase the protection of policyholders against insolvencies of insurers. The initial draft of the Act proposed federal chartering as necessary to provide the federally controlled guarantee of insurance obligations. The present draft, however, acknowledges that a federal charter is not a prerequisite for coverage under the proposed Federal Insurance Guaranty Fund. While providing no additional protection against insolvencies, the federal chartering provisions would seriously erode the quality and effectiveness of state regulation with which it would operate concurrently.

Aside from the lack of any demonstrable need for the Act and the likely detrimental impact of the measure, the overriding objection to the Act is that regulation of insurance and protection of policyholders is best left with the state regulatory authorities, which over the years have developed an intimate knowledge of the operation of the companies regulated. An added layer of federal regulation would be wasteful, confusing and have the probable effect of depriving

a large number of citizens the protection now afforded by the expertise of state regulators.

For the foregoing reasons, the LIC respectfully and earnestly urges the defeat of S. 1710 in its entirety.

September 12, 1977

STATEMENT
OF THE
MASSACHUSETTS MUTUAL LIFE INSURANCE COMPANY
ON
S. 1710
"FEDERAL INSURANCE ACT OF 1977"

Massachusetts Mutual Life Insurance Company was organized under Massachusetts law in 1851. Since its founding, Massachusetts Mutual has maintained its national headquarters (Home Office) in Springfield, Massachusetts. Currently more than 1.8 million individuals are insured under the Company's group and individual life, disability, accident and health, and annuity contracts. Ranked by assets, Massachusetts Mutual is the tenth largest life insurer in the United States.

We generally support Senator Brooke's proposal to establish an elective national policyholder guaranty fund. We also generally favor Senator Brooke's federal chartering proposal which is designed to improve the quality of life insurance regulation by requiring the States to compete with the federal government for chartering and regulatory authority.

A. The Guaranty Fund

In providing for elective participation in a national guaranty fund, the bill would protect and secure the financial needs of millions of policyholders and their families with the full faith and credit of the United States. The resources and jurisdiction of the federal government are uniquely suited to this purpose. We applaud Senator Brooke's foresight and concern

Statement on S. 1710

which are reflected in making the federal resources and jurisdiction available to the life insurance industry and its policyholders.

Accepting the Senator's invitation to consider the bill as only a working draft, we suggest that participation in the proposed federal guaranty system would be more attractive to life insurers if they could determine with more accuracy than the bill now allows, the costs of participation. Specifically, we suggest that the bill be amended to specify more precisely the amounts of contributions to the fund and to prohibit the commingling of life insurance guaranty fund assessments with casualty insurance assessments.

We also suggest that the vague degree of federal regulation proposed for participants in the guaranty fund system is unnecessary. The audit authority of the Federal Insurance Commission, the proposed "early warning system," and the Commission's authority to rehabilitate federally guaranteed insurers would, we believe, adequately protect the fund from unwarranted claims. Regular independent audits of federally guaranteed insurers, which would continue to be regulated by state insurance departments, should be sufficient to identify imminent insolvencies and bring into play the consequent exercise of the Commission's powers of rehabilitation.

B. Federal Chartering

The most innovative aspect of the bill is its proposal for the elective federal chartering of insurers, necessarily resulting in pre-emptive federal regulation. Although innovative in the context of insurance regulation, elective chartering has an apparently successful regulatory precedent in the banking industry. Any discussion of the federal regulation of life insurers, however, has in the past met strong opposition on the ground that it represents federal regulation for the sake of federal regulation, without due regard for the success of the states in regulating the industry. Senator Brooke's proposal does not deserve this criticism. A truly optional system of federal chartering should bring out the best in both state and federal regulators. Each would be competing to establish the soundest system of policyholder protection.

Again treating the bill as a working draft, we believe its provision dealing with federal chartering could be substantially improved. In its present form, the bill does not offer the policyholders of our Company a regulatory code preferable to the Massachusetts insurance code. For example, the Massachusetts code specifically identifies the mortality tables, interest assumptions and permissible methods of calculation a life insurer may use in computing its life insurance reserves.

In contrast to the specific provisions of Massachusetts law, the federal insurance code proposed by the bill leaves the computation of life insurance reserves to the unpredictable discretion of the Federal Insurance

Commission. We believe the bill should follow Massachusetts precedent in this area and prescribe specific methods for computing reserves. Otherwise, the policyholders of a life insurer cannot make an informed election of federal chartering and regulation.

Second, we suggest exclusive federal regulation of the forms of insurance and standards governing the contents of insurance policies marketed by federally chartered insurers. This would appear to be an appropriate concomitant to the federal regulation of the reserves which underlie the contractual obligations of a life insurer. Such exclusive regulation would assist the insurance buying public in assessing, at the point of sale and not only upon insolvency or rehabilitation, the relative advantages and disadvantages of state and federal regulation.

Moreover, exclusive federal regulation of forms of insurance and contents of policies marketed by federally chartered insurers should reduce the cost of issuing policies and prevent duplicative regulation. Most life insurers prefer to issue a policy form which is uniform in all states. The absence of uniformity in state regulation today makes it more and more difficult for a life insurance company to achieve this objective.

Third, we believe that the investment restrictions imposed by the bill on federally chartered insurers would clearly discourage the election of a federal charter. The investment provisions of the bill in its present

form would require many large, solvent insurers to make costly adjustments in their investment portfolios before they would be eligible for a federal charter. The investment provisions of the New York and Massachusetts insurance codes, under which many of the nation's oldest and largest successful insurers operate, accommodate requisite flexibility in investment decisions, without impairing solvency. Similar flexibility should be extended to a federally chartered insurer if it is to compete effectively with those chartered by the states.

The election of a federal charter would also be discouraged, if a majority vote of all a mutual insurer's policyholders is required, as the bill appears to provide. Obtaining such a vote on any subject is, as a practical matter, extremely difficult, and in some cases is virtually impossible. Election of a federal charter would offer a realistic alternative to state chartering, if the statutory election procedure required only the vote of policyholders present at a meeting called to consider the election. Of course, all policyholders should be given appropriate notice of such a meeting and an opportunity to vote in person or by proxy, whether such proxy be solicited by the management of the insurer or other policyholders.

C. Summary

These criticisms of specific provisions of the bill should not detract from our general support of Senator Brooke's proposal for an elective system of federal chartering and the establishment of a national guaranty

system - one which has a jurisdictional range as broad as the problems caused by insurer insolvencies.

Senator Brooke has consistently represented this bill as a vehicle for discussion of the federal regulation of insurance. The Senator's approach is refreshing and has greatly encouraged the serious attention our industry has given his bill. An elective federal guaranty and chartering system merits such serious attention and, in our opinion, the support of the life insurance industry.

STATEMENT
OF
THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES
ON S-1710

September 21, 1977

The National Association of Mutual Insurance Companies, known as NAMIC, an organization comprised of approximately 1100 Mutual Insurance Companies desires to have the Statement entered into the record of September 14, 1977, Public Hearings on S-1710, a bill to authorize the issuance of charters for carrying on the business of insurance and to provide for the guarantee of the insurance obligations.

Notwithstanding the fact that we find great merit in parts of the proposal made by Senator Brooke and further that we feel open competition is highly desirable. We must oppose S-1710 as not in the best interests of the majority of our members because:

1. Access by small companies is limited by the reserve requirements of the bill.
2. The bill grants automatic licensing to a Federally Chartered Company in all States, unless the Insurance Commissioner of a given State can show cause why that Company should not be licensed in his jurisdiction.
3. Assessment Companies are completely excluded.
4. The bill represents unquestionably, Federal intrusion into areas traditionally reserved for State control.

5. There is no guarantee that the open competition promised by the legislation will remain a reality once inflationary forces or social demands require rate setting through price control.
6. As a practical matter, since Senator Brooke's new proposal permits State Chartered Companies to participate in the preassessment federal insurance (against insolvency) fund, State guarantee funds would likely be decimated.
And
7. As a practical matter, State Chartered Companies with prior approval requirements could not effectively compete with Federally Chartered Companies able to quickly adjust rates up and down.

On the positive side of Senator Brooke's bill we feel:

1. It is more likely that the industry could survive a major insolvency or insolvencies using the preassessment federal insurance guarantee program than under the current system.
2. The change from Senator Brooke's measure introduced last year which creates a three man commission to control and supervise the business of insurance instead of relying on a single Federal Insurance Administrator to do so.
3. The creation of a six man advisory committee to advise the Federal Insurance Commission because it would involve private expertise. And

4. Badly needed rate relief would be available almost instantaneously; long, drawn out expensive fights with recalcitrant Insurance Commissioners, more interested in their political futures than their property-casualty rates could be avoided.

Senator Brooke's bill points out several deficiencies in existing State Regulations which should be addressed promptly by the various States.

Thank you for the privilege of extending our remarks.

**STATEMENT OF EDWARD E. PHILLIPS
ON BEHALF OF NEW ENGLAND MUTUAL LIFE INSURANCE COMPANY
TO THE SENATE BANKING AND FINANCE COMMITTEE**

This statement as to S. 1710 is submitted to the Banking and Finance Committee of the United States Senate by Edward E. Phillips, President of New England Mutual Life Insurance Company, Boston, Massachusetts.

INTRODUCTION

New England Mutual Life Insurance Company was the first mutual life insurance company organized in the United States, receiving its Charter in 1835. The Company is engaged primarily in writing a complete line of standard forms of life insurance, annuity and pension policies, on both an individual and group basis, as well as group accident and health insurance. The Company does not sell fire, automobile or other forms of property or casualty insurance. As of December 31, 1946, New England Life ranked as the 13th largest life insurance company in the United States and the 9th largest mutual life insurance company, on the basis of total admitted assets, which at that time were approximately \$5 billion.

OUR POSITION ON S. 1710

New England Life considers S. 1710 a landmark legislative proposal, in that it offers the Congress, the insurance industry and the public an opportunity to review two key concepts which could significantly affect our policyholders and the insurance industry. These two concepts are the establishment of a Federal Insurance Guaranty Fund and the optional Federal Chartering of insurance companies. We believe these are ideas which may offer great potential benefit to the public. Further, we think that in some form they will successfully survive the test of public debate and scrutiny and eventually will be enacted into law.

We are particularly pleased that our own Massachusetts Senator Edward W. Brooke is the author of these important concepts. We applaud his foresight and his interest in the problems and responsibilities of the insurance industry.

For the reasons enumerated below, at present we can offer only our strong endorsement of the concepts embodied in S.1710, as we believe the bill in its present form should be revised. We welcome the opportunity to work with Senator Brooke and this Committee, and with other committees of the Congress and with representatives of the Executive Branch, to pursue these needed revisions, which we believe are in the public's best interest.

PERSPECTIVE ON LIFE INSURANCE REGULATION

The first meaningful State regulation of the life insurance industry followed in the wake of the 1905 Armstrong investigation in New York. The pattern of life insurance regulation which resulted in large part from that investigation remains basically the same to this day. That pattern consists mainly of (a) regulation of the corporate affairs of the Company (with particular attention to its investments and financial condition) by the Insurance Commissioner of the state in which it is domiciled, and (b) supplementary regulation of product design, policy forms, marketing methods and the general relationship of the Company to the policyholders of each of the 50 states by the respective Commissioners of those states. Thus, a company such as New England Life is subject to the detailed provisions set forth in Chapter 175 of Massachusetts General Laws, as well as to major portions of the insurance laws of the several states, of which Chapter 28 of the Consolidated Laws of New York represents the most comprehensive example. This basic pattern was reinforced in 1945 by the passage of the McCarran-Ferguson Act (15 USC §1111-1115) which enunciated a Congressional policy decision that "the business of insurance and every person engaged therein shall be subject to the laws of the several states" (and conversely not subject to federal regulation).

Since 1945 the most notable trend in insurance regulation has been the adoption of regulations intended to protect the interests of consumers. These regulations, however, do not address the fundamental issue of life and casualty company solvency, and therefore fail to offer assurance to policyholders that their premium payment will result in benefits being paid in accordance with the terms of their contracts. It is perhaps this primary consideration which spurred Senator Brooke to introduce the bill we are discussing today.

THE LIFE INSURANCE INDUSTRY TODAY

Because of the increasing size, diversity and complexity of the life insurance business, many leaders within our industry believe that the present regulatory pattern with its turn-of-the-century origins needs to be seriously examined. Increasingly, companies find themselves subject not only to the regulations of the fifty state Commissioners but also to a variety of federal regulations. For example, the passage of the Employees Retirement Income Security Act of 1974 (ERISA) has subjected a significant portion of our business activities to intense federal regulation. Many companies find themselves responding more and more frequently to the Securities and Exchange Commission and the Federal Trade Commission, both of which appear to be increasingly interested in regulatory jurisdiction.

In our view, the trends appear to be clear. Insurance products and insurance investment techniques will continue to become more diverse and complex and company activities more national and international in scope. State regulation will probably not keep pace with these developments, and may lack uniformity and coherence. As a result, various federal agencies may seek to regulate in areas where they perceive a need, producing an increasingly complex and incoherent system of regulation. We therefore believe that an appropriately streamlined and structured system of pre-emptive federal regulation, through optional federal chartering, should be considered as a necessary and desirable alternative for the future.

SHORTCOMINGS IN THE CURRENT S. 1710

We have listed below what we consider to be several of the more significant revisions which should be included in S. 1710. Because the Bill is still in its formative stages we have not made drafting comments, but have concentrated only on matters we believe are of substance.

DUAL REGULATION

If Congress adopts a Federal Guaranty Fund, it probably would also require federal supervision over those companies whose liabilities are being guaranteed. Sound business and legislative judgement suggests that the federal guarantor would have a legitimate interest in the affairs and practices of the companies being guaranteed, and would seek to detect and prevent imprudent business practices before they become serious threats to solvency. The key to such supervision is obviously access to accurate and timely information concerning the affairs of the company being guaranteed.

The current version of S. 1710 makes provision for such inspection, investigation and information transmittal, and contains provisions for an "early warning" system designed to detect future financial impairment or insolvency. Because each of the states discharge similar functions, this would constitute a system of "dual regulation" which seems to us highly undesirable, and not in the public interest.

With respect to the regulation of business generally, and in particular the life insurance business, we agree with those who argue that such regulation should be made simpler and more efficient whenever possible, although no less rigorous. We believe that the adoption of a guaranty fund without the adoption of optional Federal Chartering would be a step away from the attainment of those goals. Further, we believe that serious thought should be given to a system of exclusive federal regulation of those insurers which elect a federal charter.

Our preliminary analysis therefore leads us to urge reconsideration of the current provisions in the Bill relating to residual state regulation of federally chartered companies on the grounds that such state regulation may make it impossible to achieve the goals of effective and efficient regulation.

LUMPING OF LIFE AND CASUALTY GUARANTEES

We believe that the current version of S. 1710 fails to distinguish adequately life insurance risks and casualty insurance risks, and therefore fails to provide a sufficient, clear mechanism to establish guaranty fund rates on the basis of the separate risk pools involved.

ADDITIONAL WORK NEEDED ON MECHANICS

We have noted portions of S. 1710 which will need additional attention in order for the Bill to be "workable", and summarize several of those areas briefly as follows:

- The sections of the Bill dealing with permitted investments need to be rewritten and clarified. The Bill should provide maximum flexibility in choosing among investment vehicles, subject to an overriding standard of consistency with sound business prudence. It may be necessary to provide special transitional investment rules for existing companies which have already acquired large investment portfolios.
- The regulatory powers of the proposed Federal Insurance Commission are rather vague with few if any standards to guide the Commission in the exercise of its broad discretion. We believe that more precise Congressional direction should be included in the Bill.

- The exemption from state guaranty plans granted to federally chartered companies is drawn quite narrowly. This may leave federally chartered companies exposed to liability with respect to state assessment plans although such plans are conceptually identical to the exempted guaranty plans.
- The portions of the Bill dealing with suspension and revocation of a federal guarantee certificate should be redrawn to insure the continued protection of policyholders who, in reliance on the guarantee, purchased insurance products.

SUMMARY

New England Life endorses the concepts of a Federal Guaranty Fund and optional federal chartering, which are included in S. 1710. We believe they are important concepts for the future of the insurance business and should be thoroughly and openly reviewed by Congress, the public and the insurance industry. For the reasons enumerated above, we would offer revisions to S. 1710 in its present form, and would welcome an opportunity to work with Senator Brooke, members of the Banking and Finance Committee, other Committees of Congress, and with representatives of the Administration to produce legislation which will embody these important concepts.

NEW YORK LIFE INSURANCE CO.,
New York, N.Y., November 9, 1976.

Senator EDWARD W. BROOKE,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BROOKE: Thank you for the opportunity to comment on S. 3884. Briefly, we think the bill is a good first step toward providing insurance companies an option of Federal or state regulation. But the bill addresses the problems of property-casualty insurance companies, not the problems of companies, such as New York Life, which are primarily in the life insurance business.

In my opinion, the major problem of the life insurance industry is not solvency, but rather an inability to offer needed protection at the lowest possible cost to the consumer. The fact is that overlapping and conflicting laws and regulations promulgated by the states have unnecessarily added to the cost of life and health insurance. We would be extremely interested in having the option of coming under a system of uniform Federal regulation of the entire operation of life insurance companies. S. 3884 applied to life insurance companies in its present form would only add another layer of regulation to overlap state regulation. The bill would further increase the costs of operation of life companies which chose the option of Federal regulation.

We also think that a Federal Insurance Act that would benefit the efficient, economical operation of the life insurance companies should address itself to all aspects of the business. It would regulate the products offered as well as the manner in which they are sold.

staff at your convenience.

We would, of course, be glad to discuss these matters in detail with your staff at your convenience.

Sincerely,

R. MANNING BROWN, Jr.,
Chairman of the Board.

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